



RESEARCH REPORT

ClearlySo



Report prepared for the City of London Corporation,  
City Bridge Trust, and the Big Lottery Fund  
by ClearlySo  
Published July 2011

# Investor Perspectives on Social Enterprise Financing



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## Foreword

*Alderman Michael Bear  
The Rt Hon The Lord Mayor of the City of London*

One of my priorities as Lord Mayor is to strengthen the centuries-old tradition of working to improve the lives of others. The City has a crucial role to play in building a stronger civil society, especially as the Square Mile neighbours some of the poorest areas in Europe. City workers are neither insulated from, nor indifferent to, the effects of poverty on individuals and communities.

With a strong history of philanthropy, I'm delighted that in recent years the City has also played its part in developing the social investment market. Recent events have demonstrated markets are a product of society and must reflect society's concerns. To this end there is a growing realisation that alongside profit, financial services should consider how to maximise benefits to society over the long term.

The City of London Corporation has long understood that financial services have an important role to play in securing sustainable development. Indeed, the City of London Corporation itself was a founder of the London Accord; a co-operative research project intended to share thinking around sustainable investment opportunities. Further, in association with the UK Sustainable Investment and Finance Association (UKSIF), the City of London Corporation is proud to reward innovation in sustainable finance through its annual Sustainable City Awards.

To encourage this nascent market further, I am delighted to welcome *Investor Perspectives on Social Enterprise Financing*, a new research report commissioned by the City of London, City Bridge Trust and Big Lottery Fund, three organisations with a deep interest in social investment. The report explores what more could be done to attract the talent and resources of investors who wish to generate both social and financial returns.

ClearlySo has written a report that builds on studies done by, among others, JP Morgan, NESTA and the Young Foundation. The report is very timely given the establishment of the Big Society Bank.

The City has a skilled, productive workforce capable of tremendous innovation. This creativity has produced new forms of finance, allowing social enterprises to seek the right type of funding at the right time. But there is still much more to be done and the City of London Corporation will continue to play its part.

The report makes clear that we need to be patient as well as pro-active. It will take time to establish both the financial and social track records of these forms of investment. Given the challenges ahead it is heartening that the report shows how much interest a wide range of investors take in social finance.

The City has already done much to support social enterprise and remains committed to continuing that support. I hope that this report will encourage others to apply their time and expertise to the development of the social investment market.

## Foreword

*Nat Sloane  
England Chair, Big Lottery Fund*

The Big Lottery Fund is committed to bringing real improvements to the communities and lives of people most in need. Our mission is paramount and we embrace social investment as a path to achieving this mission. We see this as a new way of funding to deliver social impact. At a time when the voluntary and community sector is facing unprecedented challenges, we welcome this report and the insight it provides into current opportunities for, and barriers to, growth of the social investment market.

BIG has made initial steps into the market. The Peterborough Social Impact Bond (SIB) is a prime example of our activity in this field. The SIB has brought together seventeen social investors in a scheme to reduce repeat offending by those completing short sentences in Peterborough Prison. It is regarded as a landmark social investment initiative which has pioneered the approach to payment by results across the UK.

BIG, as the named distributor of funds drawn from dormant banking accounts, is working closely with the Government and the social investment sector to inform the shape of the Big Society Bank as an independent organisation. We are hosting an interim Investment Committee that will make investments from dormant account funds while the Big Society Bank is being established. We will continue to play a role in supporting this sector as it grows over the coming years.

This report highlights the key role intermediaries have to play in helping investors and investees meet common aims. This chimes well with our distribution of the funding through the Investment Committee: £5 million in England into social investment intermediaries. Our aim is to build the diversity and resilience of the social investment market by investing in well-managed, ambitious and financially sound social investment intermediaries. This will enable charities and social enterprises to better access capital for their work with communities. Bringing the players and the finance together will address need in our society and deliver more change for the better.

Given the intricate nature of the social investment market, it is perhaps unsurprising that the report does not offer a 'one size fits all' solution to the challenges of the sector. It does, however, provide invaluable insight into the requirements of investors and paints a very positive picture of the desire of investors to engage with social enterprises to drive innovation and achieve social impact.

We commend this comprehensive and insightful report. On behalf of the Big Lottery Fund and all those involved in the development of this report, we hope this discussion provides not only clarity on the issues facing the complex arena of social investment but a direction for the strengthening and growth of this developing market.



## Executive Summary

This report, prepared by ClearlySo, was commissioned by the City of London Corporation, the City Bridge Trust and the Big Lottery Fund. The aim of the research is to understand more fully the perspectives of different types of institutional investors towards financing social enterprises; that is, social investment. The research asks, “What engages investors in social enterprise investment?” “What is the current level of interest?”; “What is deterring investors and what could improve and accelerate the take up?” and “what existing and potential vehicles might suit different types of investors?”

This timely report reflects the growth of attention in this sector. Investment into social enterprises in the UK last year amounted to just £190m<sup>1</sup>. Yet, this belies the increasing interest in businesses which create financial and social returns by tackling society’s current and future needs. The Coalition government’s Big Society Agenda, the increased interest in Socially Responsible Investment<sup>2</sup> and the role that social enterprises plan to play in the reconfiguration of public service delivery all exemplify this interest.

### What engages investors in social enterprise investment?

This nascent sector offers a blend of financial and social returns, which benefits its customers, investors and society as a whole. The precise blend will vary according to the type of investment opportunity. Over time, the sector aims to provide investors with an increasing number of initiatives offering near market level financial returns alongside measurable social returns. The willingness to engage with the sector will grow as the social enterprises themselves offer nearer market rate returns.

### Why are institutional investors important to the sector?

Institutional investors could be important to the sector’s long term growth. The sector has been heavily dependent on government and philanthropy, and these need reinforcement. The global pools of capital which operate out of the City of London could provide exactly that. Additionally, the social investment sector is innovative and seeks to collaborate with the best minds in conventional corporate finance to produce highly successful enterprises and investment products. This would create a better fit between the enterprises’ investment proposition and the investors’ requirements.

Without adequate investment, there is a risk that the high expectations of the social enterprise sector to help meet society’s needs will not materialise. To date, despite interest, there appears to be little engagement from the City and institutional investors to provide the financial backing required and very little actual activity. The social finance sector is self-contained. Currently, the top ten providers of social finance were responsible for 96%<sup>3</sup> of UK social investment in 2010. Government has spent over £350m<sup>4</sup>

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<sup>1</sup>Of this, the majority is in the form of social banking – exact figures not available

<sup>2</sup> 25% per annum till 2014 anticipated – Robeco, Booz & Co, 2008

<sup>3</sup>Growing Social Ventures, Young Foundation, 2011

<sup>4</sup>Growing Social Ventures, Young Foundation, 2011

in support for this sector over the last eight years. High net worth individuals and charitable trusts have invested directly and through intermediaries into this sector. But institutional investment into social enterprise is either un-quantified (as in the case of retail bank lending to the sector) or negligible (as in the case of other investors).

### **What would make institutional investors engage in social enterprise investing?**

Our research helps to understand and narrow the gap between what is desired by investors, and investment vehicles designed to fund social enterprises. Our research found that in general, investors are likely to engage if social investment can offer:

- *An expectation of* market or close to market returns
- Some guarantee or mitigation of risk while approaching market level returns; protection of the downside is more important than potentially high upside
- Liquidity if possible, which helps reduce perceived risk
- Robust measurement of the social returns generated by the investment
- Larger-sized investment opportunities e.g. through pooled funds
- Products and managers with a track record in which City institutions can develop confidence

The precise investment requirements vary from one investor to another. No one size or shape fits all. We found that charitable trusts had more tolerance for lower returns and smaller size propositions, but they emphasised the need for potential to scale and for clear exit strategies. Socially Responsible Investment (SRI) fund managers seek liquidity and market level returns, preferring listed share structures. Pension funds, for example, could invest in closed funds more easily than the SRI counterparts and they look to a strong track record of the fund originator as a key criterion. Retail banks avoid risky lending and compete to offer debt to the sector. Independent financial advisors and financial consultants, with a few notable exceptions, are broadly absent from the field of social investment, both through lack of information and a poor fit of business priorities.

### ***Supply of suitable products to attract institutional investors***

#### **Existing products**

Existing social investment products broadly meet their target audiences' requirements. But with a few exceptions, the target audience is not the institutional investor: it is the philanthropic and individual investor, who is prepared to accept sub-market financial returns blended with social returns. When we matched specific preferences of different institutional investor types against available products, we found certain gaps where there were no suitable UK social investment products on offer.

Existing investment products make effective use of 'tiered' structures in which donations and loans are layered into one vehicle. However, the less philanthropically focused products on offer do *not* generally make use of underwriting or guarantee to lift the returns or to mitigate the risk. Moreover, most of the social enterprise investment

products are illiquid, making it hard for investors to exit an investment. This adds to the investor's perception of risk.

Some ethical shares and social bonds (loans) do offer near to market returns, but these are also relatively illiquid. Ethical shares are traded under a 'matched bargain system' often with limited trading histories and social bonds loans have little traditional market exposure. The latter are largely financed by the social finance sector.

These factors contribute to the low levels of engagement by institutional investors in the social enterprise sector. Encouragingly, the rapid and constant innovation in the sector suggests that these problems are being addressed in new product design. The list of products (given in the Annex of the report) that are currently available or under development, illustrates this point. As the sector develops, the number of organisations reaching nearer market level returns will grow.

### **Future product design**

Future product design could take into account the commonly identified requirements of expected near to market rates of return, need for liquidity, risk mitigation, investment size and social impact measurement. Importantly, investors prioritised the protection of downside over the possibility of higher rates of return on the upside. Where investors perceive a deal as attractive but risky, the possibility for early stage underwriting, guarantee or different return structures across investors may provide a solution. In such structures, sources of capital with different social and financial objectives are "blended" in order to secure greater overall flows of funds. We see these deals being implemented on an international basis. Further use of pooled products could support public sector spin-outs, help to diversify the risk across the portfolio, raise the minimum investment size and provide some economies of scale.

Good product design will result from an interactive process between enterprise, intermediary and investor. Even though product design is less important than the underlying investment on offer, a well-constructed investment vehicle, designed with the target investor(s) in mind, can make it easier for an institution to engage in a social investment, *if* the proposition is attractive. The products under development are incorporating a number of these points and the most successful products will be developed in collaboration between investor, intermediary and investee.

### **The role of the Big Society Bank**

The Big Society Bank, (BSB) will, if suitable terms are agreed with the four commercial banks, and the various regulatory hurdles are cleared, provide £600m of new capital for the social sector. Its creation can play a key role in developing the social investment marketplace. The BSB intends to develop new investment products, to be an early-adopter of social investment concepts, to support financial intermediaries, to co-ordinate social impact work and to act as a champion to lever in additional finance. Its role as an underwriter will be balanced against its ability to reserve capital for future years as the sector continues to develop. We are likely to see imaginative partnerships



across social and traditional financiers with the BSB sharing risk and creating products which have a real chance of achieving scale and impact.

### ***Key recommendations to accelerate social investment***

#### **Support intermediaries in building up the social investment market**

Just as products need to be more flexible, so do the social enterprises themselves. Generally, the supply of “backable” propositions has been seen as inadequate by investors - a shortage which cannot be easily corrected through product engineering or packaging. However, there is evidence (from those involved in the process) that this supply is growing. Intermediaries have a substantial role to play in helping investor and investee meet common aims.

We suggest the following points would help to match requirements with opportunities:

- Intermediaries to help match target investors’ requirements with investees’ needs, through design and structure of suitable investment products
- Intermediaries to advise, inform and promote social finance opportunities to key players in the City, particularly to consultants, Independent Financial Advisors, fund managers and trustees
- Social private equity funds and social business angel networks to mentor and support immature social enterprises until they are ready for the more conventional markets in which City institutions are generally active

#### **Development of infrastructure and products**

- BSB to support the development of platforms, ensuring that these are developed in an integrated way that allows access to products for a wide range of investors to help build up liquidity over time
- Use the findings of this report as a basis for tailoring products to suit particular target investors
- Consider ways of supplying guarantees and underwriting (e.g. through UK’s access to European Union budgets, through other institutional finances, through use of Big Society Bank resources, and / or others)
- Create pooled financial vehicles to build up economies of scale and diversify social investment portfolio, using structures which allow target investors to engage

#### **Public policy recommendations**

- Lobby for greater use of fiscal incentives to encourage investment into the sector
- Provide clarity over contracting arrangements for spin-outs and the role of impact in commissioning generally (this is vital to reassure investors in the business proposition)
- Consult on proposals to establish an appropriate finance regime for social and community finance, to provide the same exemptions to financial promotions across all legal forms of social enterprises

- Central government to assist local authority budget holders to identify potential savings across departments from public purse and base service contracts on this as well as on specific social benefit criteria

### **Impact measurement recommendations**

- Hold investors' forums to understand the level and type of detail they seek to make and maintain a social investment; build this into a co-ordinated work strategy on social impact measurement
- Work with other networks internationally to exchange best practice and harmonise approaches as far as possible

### **Analyse the sector and champion its key successes**

- Analyse key features of the UK social enterprise sector, for example, its loan default rate, average length of time to reach sustainability etc; use findings to promote its strengths as a sector to investors
- BSB with independent intermediaries to develop a bank of case studies, best practice examples from UK and beyond; encourage exchange of experience particularly amongst new social entrepreneurs
- Big Society Bank , intermediaries, enterprises to champion the sector to investors and to potential collaborators

### ***Conclusion***

The social investment sector has already made tremendous progress across the board in the last decade. It needs to continue to work through a wide range of clear, specific and detailed actions, whilst maintaining its dynamism to meet the broader aims of the sector. We see the Big Society Bank as having the potential to be a game-changer in providing focus for many of these issues. It is likely to have the funding, expertise and weight required to champion the cause of social investment and to bring the City and its institutions more fully into play. This report discusses practical ways to attract investors into the sector and to seize larger scale new investment opportunities, such as those generated by financing needs of the public sector spin-outs.

There is much benefit to be gained by the many innovative social intermediaries and entrepreneurs working closely with interested institutional investors. Over time, the sector could then meet its dual aims of increasing the level of actual transactions and of integrating social and financial considerations within the business agenda. We believe that the findings of this report can help to frame such collaboration.



# **1 Introduction to the Project**

## **1.1 Project scope**

The City of London Corporation, City Bridge Trust and the Big Lottery Fund commissioned this report to understand more fully the perspectives of different types of investors towards investment into social enterprises. By exploring and detailing these, products can be better tailored to meet the needs of investors and to help to develop the market. The ultimate aim is to facilitate growing institutional investor participation in social impact investing.

To inform this, the research examined:

- Current levels of activity in the City for social impact investment
- The appetite for increased social investment activity
- How different institutional investor types viewed social investment
- Whether there were structures to accommodate social investment within investors' organisations
- The critical features for investors in making a social investment
- The fit between existing or new investment vehicles and investors' requirements
- The extent to which social investment is an emerging asset class

The report provides actionable recommendations around the structure of investment vehicles and mechanisms to enable these, which would help to accelerate the take-up of social investment by institutional investors in the UK.

The emphasis of this report is on the appetite for institutional investors to engage in social investment. This is for two key reasons: firstly, there has been less research into this area of potential investment than into individuals' appetite for social investment and secondly, the institutions hold the major pools of capital. As the sector grows, increasingly it will seek capital from these financiers.

## **1.2 Advisory Panel - composition and thanks**

The research benefitted from the support and input of an Advisory Panel. We would like to thank them for the time and guidance they provided to this report and for all they are doing to throw light on and support action in to social investment within their varied institutions and capacities. Members of the Panel are listed in Chapter 14 of the report.

## **1.3 Structure of report**

The first three chapters lay out the background to the research. The findings relating to different types of investor are detailed in Chapter 4, with Chapters 5 through to 9 examining specific issues in more detail, for example looking at how well existing vehicles fit with investor preferences (Chapter 7) and the role of the Big Society Bank (Chapter 9). Chapters 10 and 11 highlight the recommendations arising from the research and conclude. The annexes to this report contain a range of supporting

information, including a review of different social investment vehicles in existence or under development.

## 2 Scope, Remit and Methodology of the report

### 2.1 Definitions and Exclusions of Report

#### 2.1.1 Social enterprise definition

This report focuses on investment into social enterprises and social purpose businesses or initiatives, predominantly within the UK, as highlighted in Figure 2.1.1. There are no precise definitions of the terminology used in the sector but we have worked on the following basis:

**A social enterprise<sup>5</sup>** can be defined as an organisation or venture which achieves its primary social, ethical or environmental mission using business methods. From an investment perspective, social enterprises must 'principally' direct financial surpluses back into the business or the cause it serves. Some of these enterprises have chosen to impose this financial redirection through an asset-lock (which ensures that the organisation's assets are only used for community purposes). Charities generating income, Industrial and Provident Societies and Community Interest Companies (either limited by guarantee or by shares) have such asset locks. Other social enterprises may have no legal arrangement for the redirection of financial surpluses, but may state this commitment in their Articles of Association.

**A social purpose business<sup>6</sup>** (or social business) has a commercial objective, to achieve and increase profits and realise growth, and a social objective. From an investment perspective, social businesses can distribute dividends or create value through capital appreciation. These businesses may also take asset locked forms.

**A mutual<sup>7</sup> and employee ownership** exists for the principal purpose of delivering a benefit to their members. Those members can be employees, customers, other key stakeholders, or some combination of all three. While a number of mutual organisations fall under the government's definition of social enterprise, i.e. they have a social purpose and principally reinvest their surpluses into the organisation or toward wider community goals; mutuals are not by definition social enterprises. However, they are increasingly being used as common noun in policy making to describe the organisations that may spin-out of the public sector to provide services for the state to the public.

Where the investors interviewed voiced preferences to finance enterprises with or without the asset lock, these are recorded in our findings.

**Mission Connected Investment** is defined as investment by foundations which promises a market return but also helps to achieve mission (New Economics Foundation, Mission Possible 2008).

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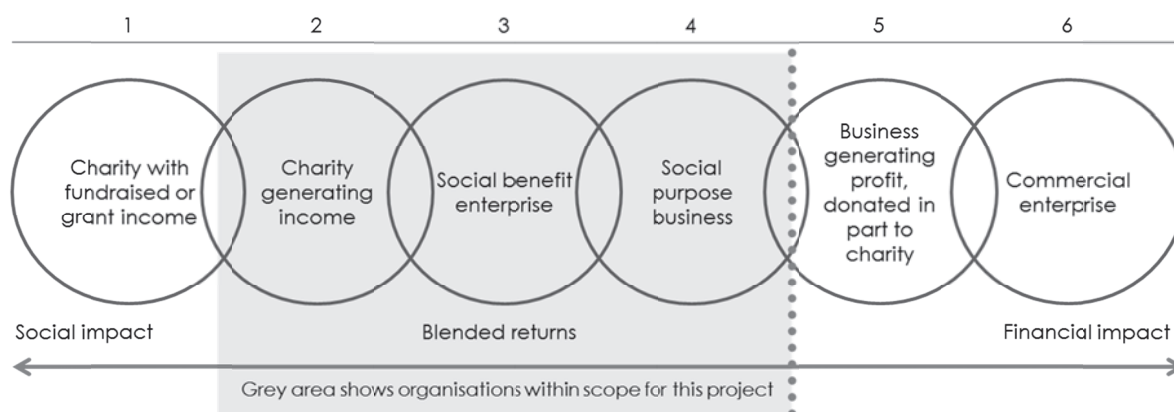
<sup>5</sup>Definition used by ClearlySo

<sup>6</sup>Definition used by ClearlySo

<sup>7</sup>Taken from Baxi partnership website,

**Programme Related Investment** is definite as investment by foundations primarily for mission purposes which generate returns that are typically below market levels (New Economics Foundation, Mission Possible 2008).

**Figure 2.1.1 Spectrum of social organisations**



Source: Adapted from Cheng et al. (2010, Venturesome)

## 2.1.2 Socially Responsible Investment (SRI) and Impact Investment definitions

### Socially Responsible Investment<sup>8</sup>

This refers to the incorporation of environmental, social or governance (ESG) issues into investment decisions and ownership practices. It can be achieved through negative screening, eliminating investments that are not compliant with ESG standards, or it can be a positive approach to investment, actively seeking out those with high ESG compliance. 'Broad' SRI includes engagement by fund managers with the company to ensure responsible ownership and ESG standards; 'core' SRI offers investors opportunities to invest in those companies which have met their ESG requirements.

### Impact investing

Impact investing overlaps with socially responsible investing but its driver for engagement is the impact that an investment can create. It can be described as "actively placing capital in businesses and funds that generate social and/or environmental good and a range of returns to the investor, from principal to above market" (Freireich, J. and Fulton, K., 2009).

Impact investing is already taking place across a wide range of sectors, but the most well-developed of these are micro-finance, social housing and clean technology. Infrastructure initiatives, such as water purification and access to technology, could also be categorised as impact investing. This category of investing is likely to grow – one estimate suggests that within 5–10 years, this could represent 1% of estimated assets under management – to about \$500bn (Freireich, J. and Fulton, K., 2009). Over time, it

<sup>8</sup>UKSIF and Eurosif based definitions

may encompass more sectors as innovative ways to deliver services and create products are developed.

**A Social (Impact) Investment or social enterprise investment<sup>9</sup>** is a sub-category of impact investing. In the context it is used in this report, it refers to investments made into social enterprises and social purpose businesses designed for the purpose of creating social impact. Social investment also focuses on the balance and possible trade-off between social return and financial return. Another point of view is that all impact investment has a social component and therefore the distinction is false. However, for the purposes of this research, which does not consider other forms of impact investing, for example clean tech microfinance, we maintain the above definition. We refer to it throughout as 'social investment'.

**Finance First** investors seek to optimise financial returns with a floor for social impact.

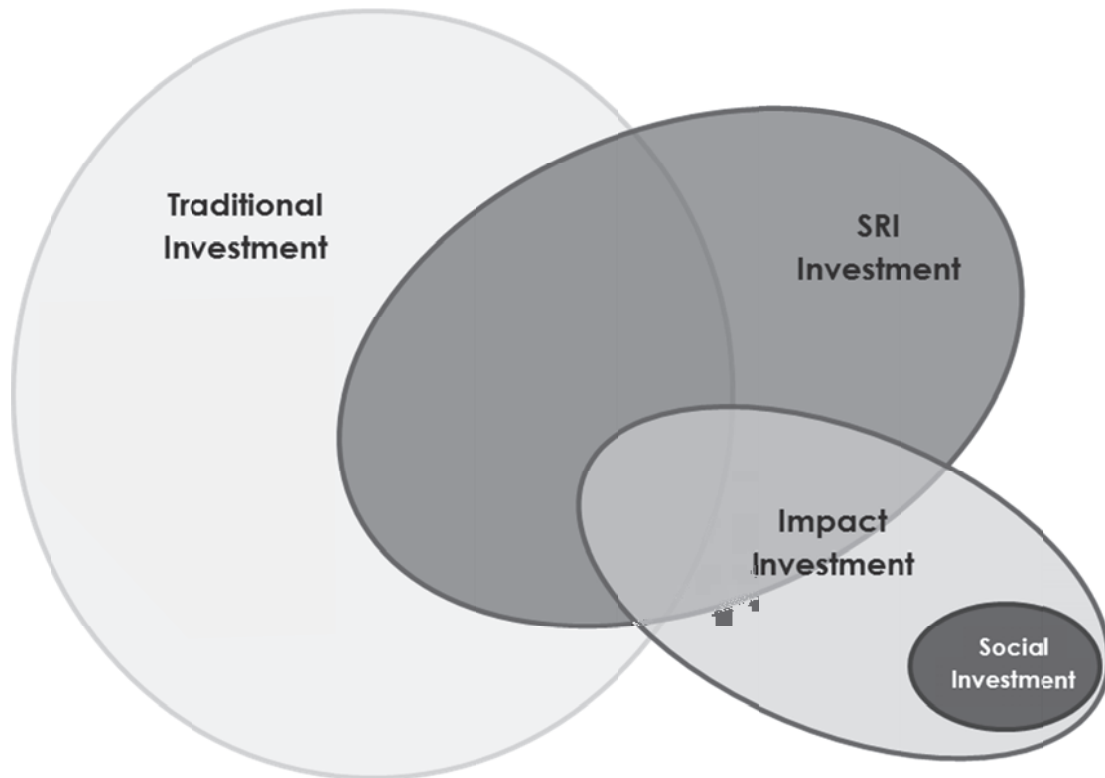
**Impact First** investors seek to optimise social impact with a floor for financial returns (which could be approaching – 100%, such as in a grant). Whilst there are blurred boundaries, and investors cannot be so easily pigeon-holed, the Venn diagram in Figure 2.1.2 maps out the interactions between these forms of investment (Freireich, J. and Fulton, K., 2009).

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<sup>9</sup>Based on ClearlySo and others' definition



**Figure 2.1.2 Social and Impact investing within the context of SRI and mainstream investment**



### **2.1.3 Definition of an investment vehicle**

An investment vehicle is a security or derivative. It may be rigidly structured, as in an asset-backed security, or it may be quite basic, like a stock or bond. An investment vehicle is a mechanism aimed to make a profit on the capital one has invested in it. Examples of social enterprise investment vehicles include the Social Impact Bond<sup>10</sup>, Scope's layered financing model<sup>11</sup>, Allia Charity bonds<sup>12</sup> Bridges Ventures Social Entrepreneurs Fund<sup>13</sup>, Big Issue Invest<sup>14</sup> and Charity Bank<sup>15</sup>.

### **2.1.4 Excluded sectors of impact investing**

This report does not focus on specific investor preferences for microfinance, social housing and environmental propositions, except in so far as they may be 'bundled' in with social investment opportunities or strategies. We are particularly conscious that

<sup>10</sup> [http://www.socialfinance.org.uk/services/index.php?page\\_ID=15](http://www.socialfinance.org.uk/services/index.php?page_ID=15)

<sup>11</sup> <http://www.scope.org.uk/news/grangewood-venture-philanthropy-project>

<sup>12</sup> <http://www.guardian.co.uk/society/2010/jul/14/local-bond-invest-job-creation>

<sup>13</sup> <http://www.bridgesventures.com/social-entrepreneurs-fund>

<sup>14</sup> <http://www.bigissueinvest.com/>

<sup>15</sup> <http://www.charitybank.org/>

social housing has proved to be an important sector for impact investment and has generally offered the attractive combination of financial and social returns. Importantly however, it does not face some of the shortages of capital that other social investment sectors contend with. Where we have discovered social housing investment from institutional investors or as part of an investment product, we discuss this (for example, in the case of the Allia Bond in Section 7.3.5). To date, social investment in the UK is not as well developed in the products or in the opportunities offered for investment as social housing. However, the developments of the sector have some relevance and are an interesting extension of the research covered here. We refer to articles on the growth of impact investment and sectors within it, where appropriate (for example, Cheng, P., 2011).

#### **2.1.5 Excluded investors into social enterprise: High Net Worth Individuals (HNWIs) and business angels**

As stated in Section 1.1, the emphasis of this report is on the appetite for institutional investors to engage in social investment. As the sector grows, increasingly it will seek finance from these financiers. We have excluded investors which carry out their social investment decisions outside the structure of a financial (City) institution. Where an individual or business angel network seeks advice or instructs a wealth advisor on social investment opportunities, we aim to capture this at the institutional level – as the wealth advisor responds to client's demand for social investment. This is not to understate the potential driver that High Net Worth Individuals (HNWIs) have played (either as individuals or through foundations they have established) or that they might play in the future in accelerating social investment. In fact, we see this category of investors as possible trend setters for more institutional players to follow. However, as their involvement and their appetite to engage further is well captured in other research from the UK (Elliot, A., 2011) and US (Neighbor, H., Ulrich, G., and Milikan, J., 2010), their direct involvement remains outside the remit of the project. Instead, the report focuses on the less researched institutional appetite for social investment, recognising that these individuals have done much to bring forward this sector's progress.

#### **2.1.6 Excluded sectors of social enterprise: Industrial and Provident Societies (IPS)**

Investment into IPS structures has been predominantly at community level rather than at institutional level. Where we have uncovered investment vehicles to attract institutional investment into IPSs, we refer to these.

#### **2.1.7 Geographical exclusions (UK focused)**

The focus of the project has been around UK based institutional investors' preferences for social impact investment and this has tended to focus on the opportunities offered nationally. However, many of the investors included in this research represent international organisations and the range of impact investing opportunities open to them is beyond the UK. UK social investment, while it may draw on best practice and

collaborate with partners globally, remains the sole focus of the document. This is a function of the remit.

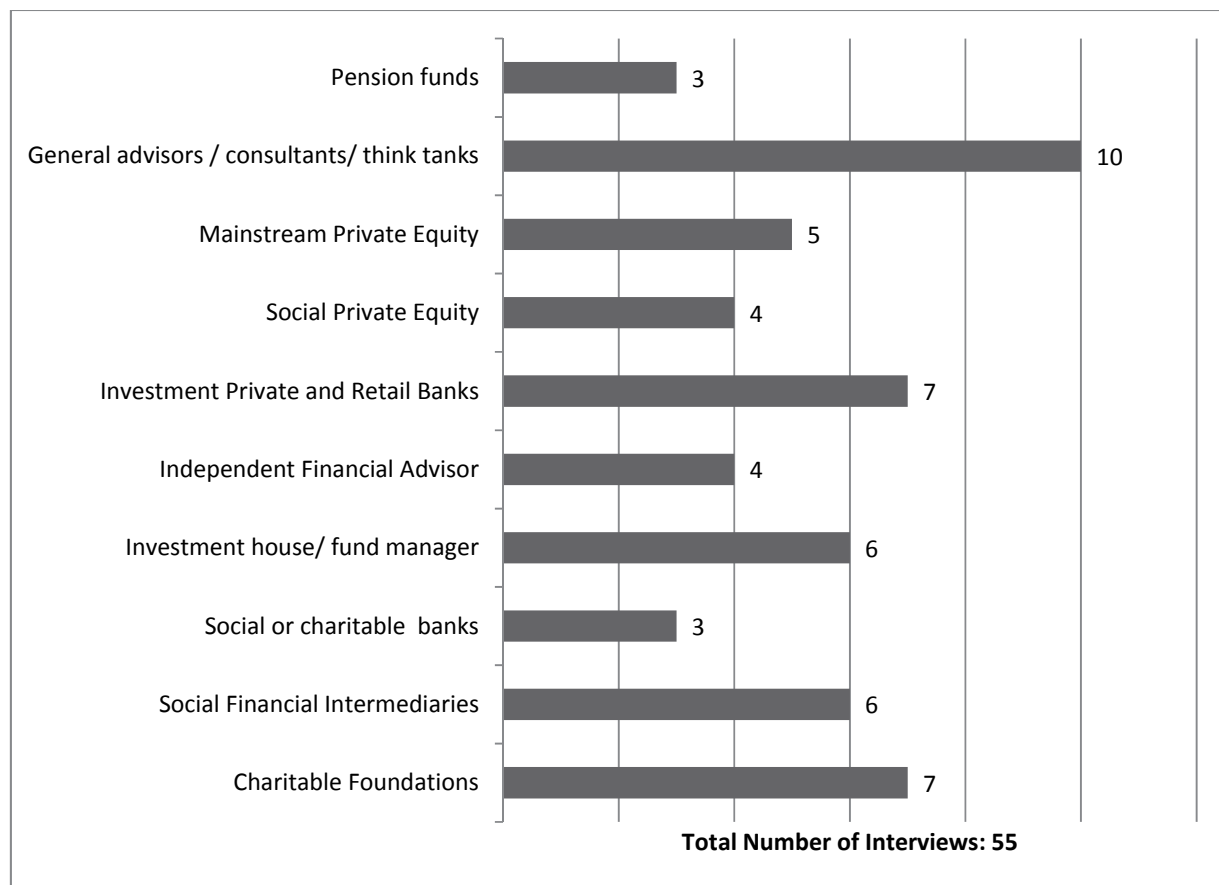
## **2.2 Methodology of the report**

### **2.2.1 Interviews undertaken by investor type**

In addition to researching publically available material, we surveyed a sample of different types of institutional investors. The organisations surveyed were categorised under the headings represented in Chart 2.2.1. Those who agreed to engage with us were sent a detailed questionnaire, on the basis of which we conducted interviews. In total, 55 individuals were interviewed or consulted. This included ten informed persons on social investment and six social financial intermediaries, not in themselves investors. However, their views were solicited on issues around the investment decision, the vehicles, their attractiveness to investors, their perception of the overall social investment market as well as barriers to further investment and possible solutions to these. Only four refused interviews, and the common reason given was time pressure.

Not all investors answered every aspect of the questionnaire – some felt that they would be driven entirely by client demand and therefore were not able to predetermine the preferences they would give to one feature over another in an investment vehicle. This shows the extent to which investment in this sector is a bespoke service, tailored to fit clients' preferences. When questionnaires were sent out without requests for interviews, we had a less successful response rate, and found it hard to engage with many of the financial advisors and consultants. The sample is not equally distributed across investor types, partly because it was harder to gain access to some groups of investors than others. Chart 2.2.1 shows the number of interviews completed by investor type.

**Chart 2.2.1 Number of Interviews Completed: Total 55**



Note: Social Financial Intermediaries listed here are not investors themselves. Social Investors are included under Social Private Equity or Social and Charitable Banks.

The sample size for each type of institutional investor interviewed was small and therefore provides a snapshot of those investors' perspectives. We are, however, confident that the information provided gives important insights into the approach of investors towards social investment. There is an element of positive bias in the sampling, as the majority of people selected for interview had a known interest in or awareness of social investment (even if they were not actively engaged). A few of those interviewed were neither interested nor envisaged becoming engaged in social impact investing and they also inform the report's findings.

## **2.3 Rules of the brief**

### **2.3.1 Interviewee confidentiality; contributors listed**

Interviewees were most helpful in giving up their time to engage in this research. We list in the back of the report those organisations who participated and who chose to be acknowledged; not all participants wanted this acknowledgement. We have not referred directly to any organisation's position without prior reference to them, unless

the information provided is within the public domain, and have sought to ensure remarks are not attributed or attributable.

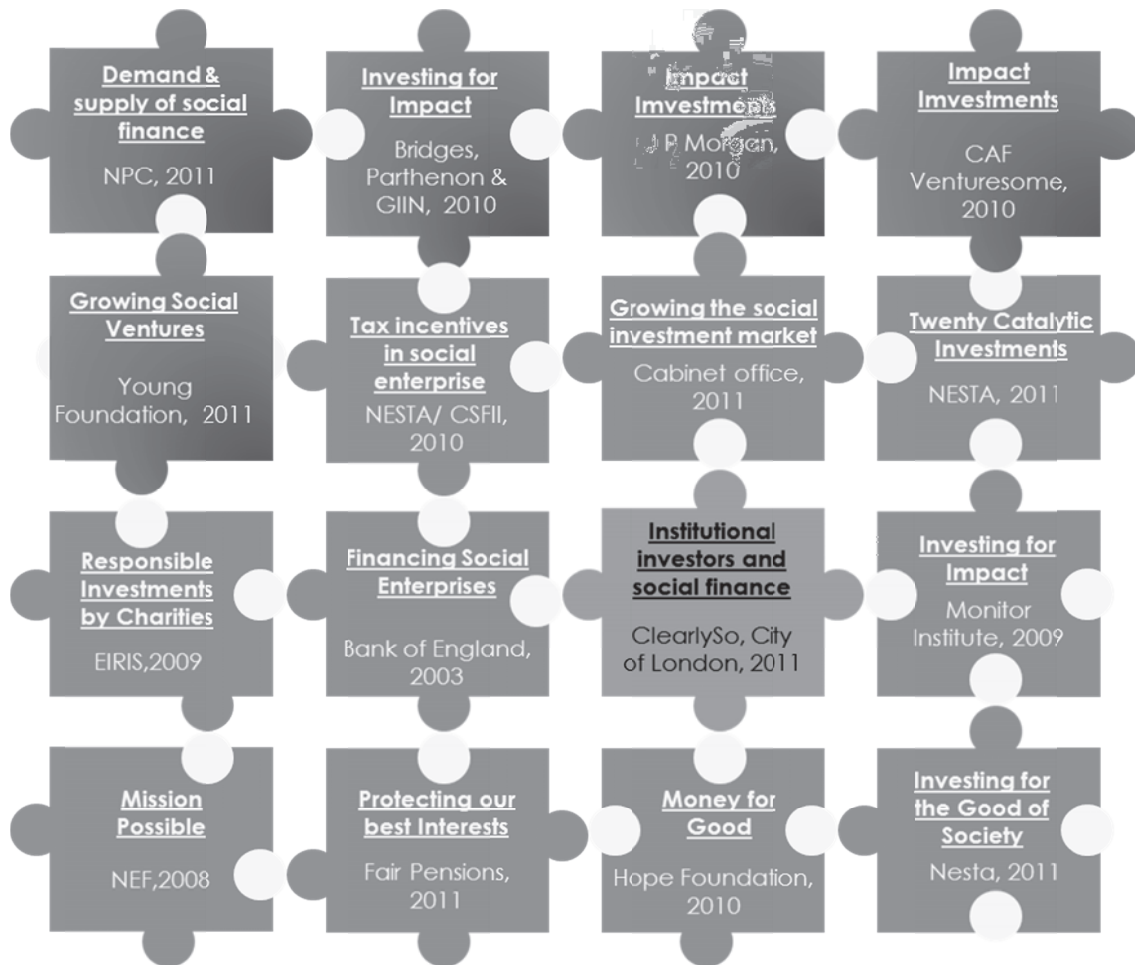
### **2.3.2 Representation of views**

The findings of this report reflect the interviewees' opinions, as assessed by the lead researcher on this project. On those occasions where ClearlySo has a particular point of view of its own, this is stated as such. Otherwise, this report should not be taken to be the opinion of ClearlySo or its management. The report was carried out as independent research for the project funders, the City of London, City Bridge Trust and the Big Lottery Fund, and their perspective is represented only in the two forewords for this report.

### **2.3.3 Research context of the project**

This report fits into a framework of recent research into social enterprise and impact investing. There has been a series of UK and US research papers carried out to assess different aspects of the potential supply of capital. Figure 2.3.3 shows how this project fits into that picture. A full reference list is provided in the Annex.

Figure 2.3.3: Research context of the project



Note: see Chapter 13 for full references

### **3 Brief Overview of Social Investment in the UK**

#### **3.1 Background context to social investment**

The concept of social enterprise is not new. Organisations with the purpose of social enterprise have existed within the British business culture for over two hundred years. The Cooperative Movement sprung out from the desire for communities to contribute to and benefit from the economic activity of their locality. The Cooperative Bank, developed as the need to deposit trading revenue grew, has been in existence since 1872.

Until early 2000s, the social investment sector had been developing in relative isolation, without high recognition or engagement from the bulk of mainstream investors. The last Labour government showed commitment to galvanizing activity in this sector and undertook a range of initiatives. It commissioned the Social Investment Task Force to examine the broad issues around this emerging sector (The Social Investment Task Force, 2000). UnLtd, the support network for social enterprises, was launched in 2000 with £100m from The Millennium Fund. Important research from the Bank of England in 2003 identified the social enterprise sector's need for patient capital, highlighting that the availability of loan, capital and angel finance for the Small and Medium Sized Enterprise (SME) sector was broadly unavailable for the social enterprise sector. Ten years later, the sector has seen approximately £300m of additional public money invested in to it from of a host of associated funds<sup>16</sup>, the development of a cluster of social venture capital funds, as well as the creation of a Cabinet Office profile for itself.

#### **3.2 Current state of social investment in the UK**

The current coalition Government appears committed to the idea of social entrepreneurship as a solution to some of society's problems, but it is fiscally limited in its ability to create a host of new funds to support it. Rather, its approach seems to be to encourage the creation of a market through the development of wholesale investment vehicles.

In May 2011, the outline plan for the Big Society Bank (BSB) was launched. This wholesale institution is to be funded out of unclaimed assets and commercial bank loans. New investment products are under development and in pilot phase. The sector has received a high public profile of late, partly in expectation that it can provide some solutions to the increasing pressure on state provision of services. This research aims to determine real levels of interest and potential engagement by City investors as important factors in taking the sector forward from here and in meeting those expectations.

The Big Society Bank (BSB) and the Green Investment Bank, whose sizes could be over £0.5 billion and £3 billion respectively, represent supply side initiatives in the market for

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<sup>16</sup>UnLtd 2001 (£100m); CDFIs, 2003 (£42m); Futurebuilders, 2004 (£125m); SEIF, 2009, (£75m to date); Community Builders, 2009 (a proportion of £70m)

finance. These sit in conjunction with 'demand side' initiatives which focus on the creation of enterprises capable of receiving investment and on generating an environment in which to foster these enterprises.

In preparation for the BSB's development and its delegated role in bringing in additional institutional capital, the Big Society Finance Fund, in partnership with the National Endowment for Science, Technology and the Arts (NESTA) and the Panahpur Trust, has seed-funded the development of four new social investment products (Ludlow and Jenkins, 2011). The range of products under development currently includes bond structures, co-investment funds and platforms to facilitate investment.

Will these products attract investors? This in part depends on how well these products fit the requirements of different types of target investors. The current research illuminates the features that different types of investors see as important. In addition, for potentially interested investors, the Annex provides a non-exhaustive list of social investment products to use as an initial source of information, current as at June 2011.

This report will also look at how Coalition Government policy on organisations that are likely to spin-out from the state to create 'civil society organisations' (Government Green Paper on Commissioning, 2010) might offer new opportunities to investors. The White Paper on Open Public Service, which would throw light on mutuals' potential to secure public contracts, has been delayed. In the Localism Bill, Local Government Secretary, Eric Pickles, has reflected the Coalition Government's intention to empower communities to be able to demand, shape and provide local public services. Meanwhile, the Charities Commission is in the process of revising the guidelines surrounding charities' investment responsibilities. This revision to regulation CC14 could open up real possibilities for the take-up of social investment by the Foundations.

With all these initiatives underway, the current research investigates whether the optimism concerning the Government and the sector's ability to provide a vibrant market for generating social impact is matched by a willingness from the financial Institutions to help finance it. It seeks to identify which, if any of them, have the freedom, interest and capacity to engage, and to suggest through what mechanisms that might be encouraged.

### **3.3 Types of social investment made**

The total amount of social investments made in 2010 in the UK has been estimated at £190m<sup>17</sup>. This compares with £55bn of small business lending and £13.1bn of individual giving (Shanmugalingam C., 2011).

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<sup>17</sup> 'Growing Social Ventures'; Cynthia Shanmugalingam, Jack Graham, NESTA, Young Foundation, April 2011



The following types of lenders, or social intermediaries, offer three broad categories of finance:

- social, charitable and commercial banks provide 'asset capital' issuing loans for long term secured debt and asset financing
- certain charities, social banks and government funds provide working and some transitional capital for social organisations to meet their current operational needs
- social venture funds and government risk capital provide growth capital for long term scale-up of activities (although most government funds are currently closed)

### **Growth capital**

Whilst it is not possible to get exact figures, the actual level of growth capital investment is likely to be less than £50m out of the £190m of total social investment. The majority of social investment is in the form of social banking. Growth is predominantly financed through unsecured loans, equity (where appropriate) and quasi-equity. There is a weakness of suitable investable propositions for this risky form of capital and some available growth capital has, to date, remained unallocated in social venture funds. Bridges Ventures and Big Issue Invest are the main providers of this form of capital. They seek to invest in social organisations that have a vision of scale, evidence of social impact and that can produce a robust business case.

### **Equity and quasi-equity**

Whilst equity is offered by most intermediaries, enterprises often cannot accommodate it, as legal structures of many social enterprises do not offer share capital. The growing use of quasi-equity or 'social loans', in which a share of the increased revenue generated by the investment is returned to the investors, helps to overcome this problem. It is still too early to provide a fully informed view on the investors' satisfaction with this asset as used in social enterprise financing, as it is operating in only a few recent investments so far. And this reflects another issue: there is not yet enough track record in the sector generally to be clear on which investment vehicles work best, using which asset classes and in which circumstances, but the picture is building up gradually with every additional deal.

### **Government capital**

The government has been the biggest provider of most types of social investment to date, offering finance to the value of £385m in its latest programmes<sup>18</sup>, through grants, unsecured loans, quasi-equity and equity products. Loans through government funds are intended to be used only where bank financing cannot be secured. The logic is to use public money only to finance investments with higher risk. One of the Government's largest programmes, Futurebuilders, invested £155m of the allocated £215m before closing for new applications in early 2010 (Wells et al., 2010). This reflects one of many tensions in the supply of capital: namely, the constant need to try to balance the supply of different types of capital with demand for it at any given time to ensure resources are most efficiently allocated.

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<sup>18</sup>Futurebuilders £215m, SEIF £100m, Community Builders £70m, and others (ACF)

### **Small bespoke finance**

Bespoke loan arrangements are common in the social sector. The median loan size in the sector is under £5,000, with the number of loans over £500,000 in single figures (Cabinet Office, 2011). This makes the sector expensive to finance as most of the deals are at the low finance end of the market, where returns will also be restricted. Unit costs per deal are high and many social intermediaries themselves seek capital support to develop new products, build capacity and fund overheads.

### **Bespoke bonds**

Investees themselves are innovative in ways to raise capital. Certain charities and social enterprises (Allia, Scope, for example) have created tailor made investment products to suit their target investors. This trend is likely to expand, as investees work with their specific relationships to tailor packages of mutual benefit. The development of charity bonds and community bonds by local community organisations is another growing trend to attract community 'buy-in' to initiatives, and the Labour government supported pilot schemes to trial this method of financing in 2008 (Brown, Baker Brown, 2010).

## **3.4 Growing demand for social investment**

There will always be a place for grants to help finance types of social organisations, particularly certain charities, which operate outside market structures. But recipients of grants are increasingly seeking loans and other financial products to help develop their operations into enterprises, thus stimulating demand for social investment. It is not clear how many of the 6,200 new charities or 1,200 new Community Interest Companies established in 2010 will seek investment in the future, but many of these could have had financing needs at start-up stages or beyond.

Additionally, many new social purpose organisations are seeking financing. Social Investment Business, which manages the government's social investment funds, received applications worth over £500m in the year to March 2010 (Shanmugalingam et al., 2011). This no doubt understates total demand as applications would also have been made to other social and commercial financiers. However, the actual level of social investment, in its widest terms, was less than half of this figure, as discussed above.

## **3.5 Potential sources of capital: building up stable long-term supply**

The Social Investment Task Force, established in 2000, presented a vision for a functioning social investment market place, to be created in part by 'unleashing new sources of private and institutional investment'. It sought to attract a small percentage of charitable endowment capital and institutional funds. It stated that:

*"if 5% of endowment capital (c £65 billion) and 0.5% of institutionally managed assets (c £439bn) were allocated to social investment, this would 'unlock over £5.5 billion of financing."*

(The Social Investment Task Force, 2010)

By 2011, there has been some progress on both fronts, but not on this scale. The current estimated size of UK charitable foundations' ring-fenced budgets for social investment is now in the region of £50m (see Chapter 4). The size of institutional capital allocated for social investment is probably of the same order but difficult to determine precisely (Shanmugalingam et al., 2011). Some may take place on a direct investor-investee basis, without using one of the listed vehicles and may not have been picked up from our sample interviews.

### **3.5.1 Social financial intermediaries**

A social finance intermediary could be considered as any organisation, with or without investment funds themselves, which acts to form links between investor and investee. They span the range of social venture funds, social banks, social investment bank advisers, brokers, consultants and some charitable foundations. At least 15 social finance intermediaries have been established in the ten years since 2000. One fund has closed and two intermediaries have merged<sup>19</sup>. The government's role as a social financier has dwarfed all other players combined. The next largest social finance funds in the UK are held by the charitable foundations, £20m (Esmée Fairbairn) and Venturesome, (with a current fund size £10m, previous commitments since 2002, £22m).

Social and ethical banks vary in their financial reach and robustness; Triodos has loan commitments of around £312m in the UK whilst Charity Bank's loan book is closer to £60m.

There is a high degree of concentration within the social sector; 96% of all social investments are made by ten social venture intermediaries (Shanmugalingam et al., 2011). The non-governmental social venture funds have successfully raised funds but have found a lack of larger scale investable propositions leaving a proportion of funds unallocated for investment. However, interviewees in this research stated that the number of viable social enterprise propositions is rising. Mentoring, pro-bono support, and real engagement from investors with investees are all seen as critical to help provide a pipeline of investable enterprises.

Social finance intermediaries are being innovative and resourceful and are currently developing many new social investment products to support social enterprise growth and attempt to entice investors. But some intermediaries have been on 'life-support' from public and philanthropic finance since their creation because the scale of actual investment activity has been too small to support them. In total, they are believed to be undercapitalized to the tune of around £100m (Joy et al., 2011). Chapter 4 discusses the profiles of social venture funds and social banks and their key sources of capital.

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<sup>19</sup>Triodos launched the Opportunities Fund in 2009 but the fund was closed in July 2011 after making only one investment; Charity Bank and Investing for Good merged in 2010

### **3.5.2 Big Society Bank**

The imminent arrival of the much-discussed Big Society Bank (BSB), eleven years on from the formation of the Social Investment Task Force, potentially provides the social intermediaries and the sector overall, with a lifeline. This wholesale institution (it will not lend or invest directly, but through intermediaries), funded from unclaimed assets (up to £400m to be remitted to the Bank over the next 5 years) and from £200m of finance from commercial banks, is expected to fuel the sector's growth over the next two decades. It is expected to provide social intermediaries with much needed working and development capital and resource support. A full analysis of the BSB is provided in Chapter 9.

### **3.5.3 Other Sources of Social finance**

This report recognises the role that individuals have played in supporting the emerging social finance market. Personally established foundations, family offices and trusts have also contributed. Many philanthropists combine donations and loans. Of all the likely sources of increased capital, High Net Worth Individuals (HNWIs) are considered key. As stated in 2.1.4, the emphasis of this report is on institutional investment from non-personal foundations and individuals, but this does not detract from the important role that they have and hopefully, will continue to play in supporting the sector generally.

## **3.6 Institutional investors**

The institutional sources of capital comprise primarily investment funds, pension funds, private equity and venture capital, commercial, investment and private bank deposits and charitable foundations. Financial consultants and independent financial advisors are gatekeepers to many fund managers' and retail clients' investment choices and therefore play an important role in enabling any investment. There is also the role that corporations can play as investors into this sector, using surpluses to invest in a diversified portfolio. This research uncovered occasional examples of corporate engagement in social investment (see Chapter 7, Products), but they were not the focus of the work as their primary function is not as investors.

To date, the level of engagement in social finance by institutional investors has been limited. Charitable foundations occupy a special place as they can be seen as traditional investors, social investors and grant providers simultaneously. A small group (five to ten, by our estimate) of Foundations are using these different investment 'pots' strategically to enhance their mission with their money. Their estimated combined capital to date for social investing is around £50m. Few other institutional investors have gained or begun to try to acquire the depth of knowledge about social investing in the same way as the active charitable foundations.

A report by the Social Enterprise Coalition, *Growing Social Ventures* (2011) found that mainstream investors do not perceive 'community-based businesses' as capable of dynamic growth. This may create something of a vicious circle: such organisations then

do not consider applying to mainstream investors for finance. According to a 2007 Warwick Business School report<sup>20</sup>, 71% of social enterprises use grants to finance their needs, compared with only 6% of mainstream businesses who seek grant support. This trend is also supported by more recent research from the Community Action Network (CAN). Institutional investors, where they do engage, tend to invest via a limited number of social venture capital funds, the largest of which are those managed by Bridges Ventures. In total, the level of institutional money invested into social enterprise growth capital opportunities is likely to be less than £50m currently. The reasons for this low level of engagement become apparent once the perspective of each investor is understood and the routes to market are discovered. These findings are drawn up in Chapter 4.

### 3.6.1 Why engage with institutional investors?

The overview above shows that institutional investors have so far played a minor role in building up the sector, leaving the start-up phase of the sector predominantly to philanthropists, foundations and government to finance. However, institutions generally are increasingly interested in new investment opportunities and judge impact investment (of which social investment is a part) to be a potential growth area. As and when social investment might start to provide the risk adjusted returns that investors seek, institutional investors, who manage, the world's largest pools of capital might become more engaged.

**What is the case for attracting institutional investors to the social enterprise field? What advantages could they bring and what needs could they meet?**

Our research suggests the following:

1. **Institutional investors could help supply long term, stable growth capital.** Government fund capital and temporary funds may not be able to underpin the sector's need for secure stable flow of finance for long term growth
2. **Appetite has not been fully tested to date** because of limited access to a weak range of social investment products to date
3. **Government funds are nearly exhausted.** BSB funds will not directly replace these, there may be a funding gap of the right forms of capital in the medium-term
4. **The BSB will need financial support to meet expectations:** it will aim to leverage additional finance to support its work (as stipulated in the Outline Business Plan)
5. **Slow growing social venture capital funds** may not be able to keep pace should demand grow<sup>21</sup>, as expected, in part to finance public sector spin-outs
6. **Institutional investors could help to reduce the concentration of investment deals** within the sector by spreading the potential investor base

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<sup>21</sup> Bridges raised £11.75m in 3 years, and Big Issue Invest have raised £7m since 2009

7. **Institutional investors could bring the best of both worlds to bear on social finance:** greater collaboration could help create well-tailored products to meet investors' needs
8. **Social impact concept and measurement could become integrated** beyond the field of social enterprise into traditional investments and businesses

### 3.6.5 What is the social enterprise proposition on offer to institutional investors?

Social Enterprises or social purpose businesses offer a range of blended financial and social returns to investors. As organisations, they could sit anywhere on the following spectrum:

**Figure 3.6.5: Spectrum of Social investment proposition**



What distinguishes a social enterprise from charitable models is its attempt to work in an entrepreneurial fashion in the market economy, rather than rely on the traditional grant and donations-oriented model of the more classical charity.

Our research suggests that any investment proposition on this spectrum raises a number of questions for investors to determine their potential interest:

- Are both types of return, social and financial, equally important to the investor?
- Are these returns secure or predictable, even if they are low? What is the risk level associated with each social investment proposition? Are we able to use standard measures of risk analysis, or will something of what a social enterprise offers be lost?
- Can the social return be measured accurately, so it is clear what has been sacrificed for this blended return? Is it predictable, verifiable and "secure?"
- Might these returns progress from being sub-market to market level, and will social returns increase over time as social enterprises mature and their performance improves?
- Can any of the propositions be made more attractive by the inclusion of other types of investors and/or the use of different types of investment vehicles?

Answers to these questions help to identify the type(s) of investors which might be attracted to social investment opportunities and some of the important requirements they would expect to see in the investment package. We now assess the perspectives of different types of investors before beginning to match these with products available.

## 4 Institutional Investor Findings

This chapter presents the main findings of our research and interviews with institutional investors. The same questions are asked in respect of each type of investor:

- Are they already active in the field of social impact investment?
- What are the barriers to activity? What would help them invest in the field?
- What type of investment vehicles would they favour, and under what conditions?

This is followed by analysis of the particular features of each type of investor. As each of these will have a different set of requirements, we have drawn up our findings accordingly, although some common points recur. The investor groups that are analysed are, in order:

- 4.2 Investment fund managers responsible for Socially Responsible Investment (SRI)
- 4.3 Banks - investment, private, retail and social banks and Community Development Finance Institutions
- 4.4 Pension fund managers
- 4.5 Charitable foundations
- 4.6 Mainstream private equity
- 4.7 Social private equity
- 4.8 Independent financial advisors and financial consultants

### 4.1 Summary findings across all types of investors

- There is interest, but little activity to date; small pockets on which to build
- Risk adjusted rates of return requirements are hard for social enterprises to meet
- Mitigation of risk is generally more important than potential for high returns
- Lack of liquidity eliminates one key risk mitigation strategy
- Deal size is too small for most institutional investors
- Social impact measurement is perceived as vital but as currently lacking necessary robustness; investors' requirements for what should be measured differ widely
- There is a real shortage of information and dialogue with institutional investors around social investment opportunities
- Charitable foundations hold a unique role as investors and social impact generators; need to work closely with them to engage more widely
- It can be hard to find a suitable allocation in to which to place social investment
- The role of a champion within an organisation is critical to engagement
- Philanthropic or CSR engagement in the sector is progressing into a more integrated type of engagement
- In-house resources as well as finance, when offered by investors, have potential to add value to an investment
- This is a human process; understand investors' needs and begin the dialogue



## 4.2 Socially Responsible Investment Fund Managers

### 4.2.1 Description of Fund Manager

An investment fund manager assists clients in investing their money. Institutional fund managers work on behalf of large organisations, such as insurance companies or within investment houses. Most large institutional funds have a category allocated for Socially Responsible Investing (SRI) as defined in 2.2.2.

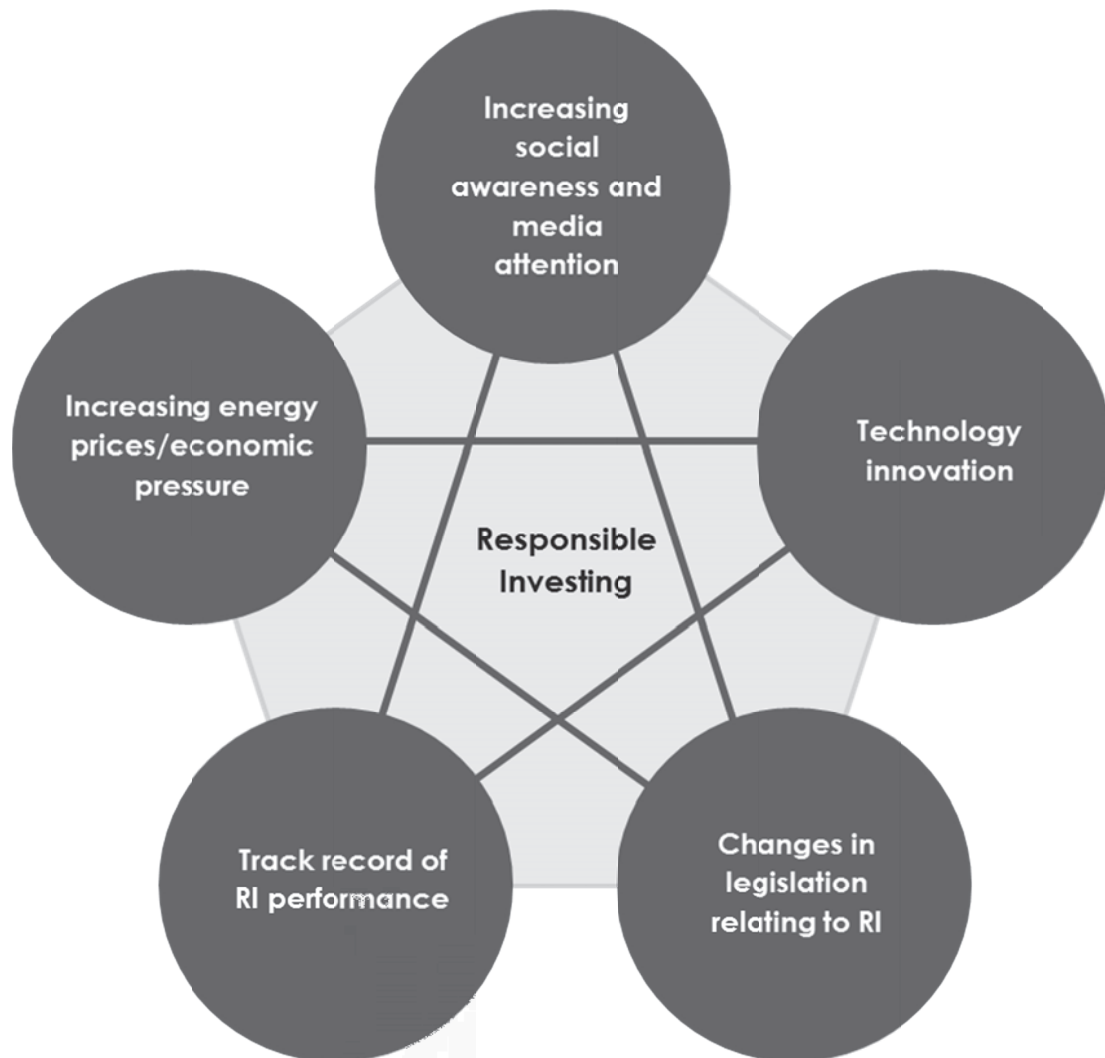
### 4.2.2 Growing interest in SRI - from niche to mainstream?

According to figures from UKSIF (European SRI Study, 2008, United Kingdom by UKSIF), £9bn of assets are held in the UK's green and ethical retail funds. This is borne out by more recent figures showing that net retail sales of Ethical funds increased to a total £74 million in the last quarter, above the average of £64 million for the past four quarters (Investment Management Association, November 2010).

There is a considerable optimism for SRI's continued growth: whilst broad SRI currently remains in a niche position accounting for only 7% of all assets under management, the Booz report (Robeco, 2008) suggests that by 2015 the market will become mainstream, growing at 25% per annum over the next 5 -7 years, reaching 15-20% of all assets under management. The market is characterised by boutiques with global players *'starting to discover the segment and moving there very quickly'* (Robeco, 2008).

The increased supply in SRI services, lobbying pressure for greater consideration of SRI and mass marketing of green issues are all likely contributors to the growth of the SRI industry. Chart 4.2.2 depicts the likely drivers for growth to SRI, and in turn, we can expect parallel drivers for the acceleration of social investment.

**Chart 4.2.2: Key Drivers for Market Change in Socially responsible Investing**



*Source: adapted from Booz & Co, (2008)*

Where does social investment fit within this? In theory, 'finance first' social impact investing should fit well within SRI, but in reality social investment struggles to hold its own in portfolios which consist mostly of large public companies. This is partly a feature of the smaller size of 'finance first' social investment opportunities and the fact that they are normally unlisted and rarely offer liquidity, making exit difficult. Nevertheless, the features of SRI investing are important in determining how social investment might fit with institutional investor strategies in the future, as SRI managers take a growing interest in the impact investing area generally.

### 4.2.3 Socially responsible investment fund managers – main findings

#### Are SRI investment funds already engaged in the social investment sector?

- SRI fund managers have difficulties allocating social investment in to their portfolios; some committed fund managers have found a small place for a few listed social investments
- SRI is more engaged in other areas of impact investing, for example microfinance, social housing, which fit the ‘finance first’ perspective, than in social investing
- Although SRI is not fully established as the default investment strategy, social investment is best placed to follow in the coat-tails of SRI’s predicted 25% annual growth rate

#### What are the barriers to activity? What would help them invest?

- The risk adjusted rates of return demanded by institutions are often seen as too high for the social sector
- Granularity of proposals and lack of a track record means each proposal requires specific considerations which are time consuming and costly
- Commonly stated barriers were liquidity weakness, difficulty in pricing in investments and lack of investable propositions (of size and returns that suit their profile)

#### What type of investment vehicles would they favour and on what conditions?

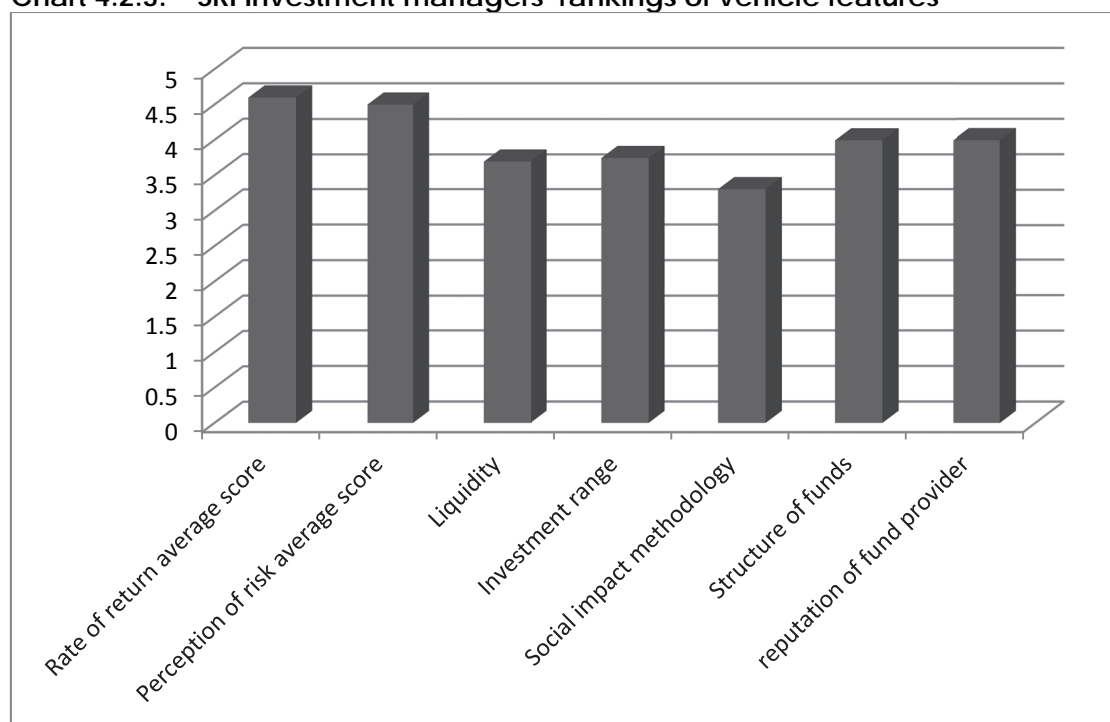
- Larger scale propositions, or investment into pooled structures, for example into OEICs<sup>22</sup>, or investment trust structures if they can offer scale and offer liquidity simultaneously
- An Exchange Traded Fund to track listed social businesses was suggested (see Chapter 7)
- Use of platforms such as Social Stock Exchange and other platforms could increase equity and liquidity in the social investment market in the longer term
- Mitigation of risk in social investment through underwriting, or guaranteeing at least of the principal sum; securing the principal is more important than offering high level returns.

Chart 4.2.3 provides a snapshot of the importance that SRI investment fund managers attached to different aspects of an investment proposition. As the sample size is small (6) and these represent average scores, it should be interpreted with caution. These same points of importance emerge across most of the investors interviewed, namely the importance of rate of return, set against the perception of risk, the need for liquidity, and for a minimum investment size. The need for robust social impact measurement is also expressed widely. The structure of the fund is critical in SRI management, requiring liquidity through trade-ability. The preference is for OEIC type structures which pool investments together and are priced regularly. The reputation of the product or fund originator also helps to shape an investment decision.

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<sup>22</sup> Open Ended Investment Company

**Chart 4.2.3: SRI investment managers' rankings of vehicle features**



Source: interviews; maximum average score per feature: 5

## **Specific Issues for Investment fund managers**

This section shows how SRI itself struggles to be the default strategy across investment fund management. It highlights the challenge involved in integrating social investing into the investment fund manager's portfolio, through its most natural host, the SRI agenda.

There are two specific challenges which face both SRI and therefore influence the room for inclusion of social investment. These are the understanding of clients' investment preferences and the integration of the social component of Environmental Social and Governance (ESG) into investment strategies generally.

### **4.2.3.1 SRI – not yet meeting clients' preferences**

Fund managers interviewed expressed some willingness to consider creating bespoke social investment products to invest in 'finance first' opportunities as long as there was interest from clients. So, how are clients' demands for this assessed and who are the main clients for SRI ?

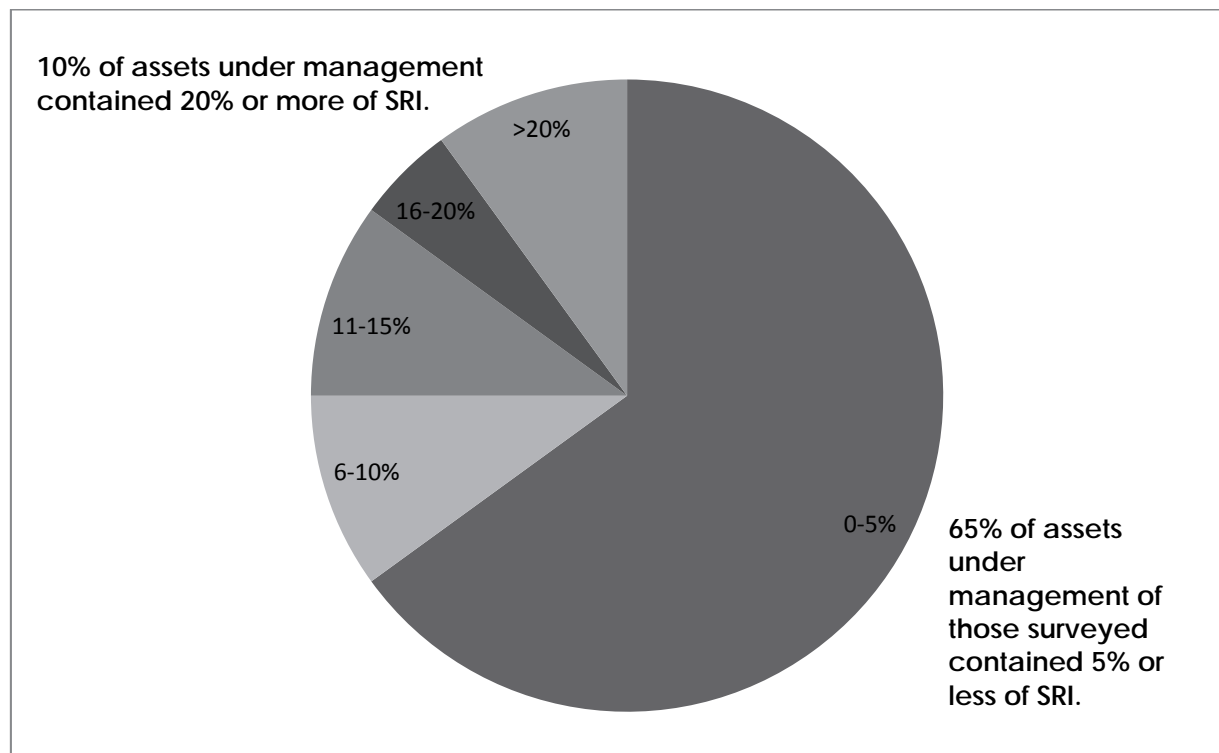
The European SRI study<sup>23</sup> identifies the core SRI investors as HNWIs, mass market investors, church and charitable foundations, occupational pension funds and insurance fund managers and asset managers. Not surprisingly, there is considerable overlap in the target group of SRI investors with potential social investors.

Research commissioned by EIRIS in 2009 (Kleinwort Benson et al.) showed that the small SRI component in most clients' portfolios may not reflect their likely preference. The survey asked fund managers:

*"What percentage of their current High Net Worth clients' assets under management includes an element of socially responsible investment?"*

Figure 4.2.3.1 shows that 65% of assets under management of those surveyed contained 5% or less of SRI.

**Figure 4.2.3.1: Percentage of Assets Under Management containing SRI component**



Source: Kleinwort Benson et al. 2009: High Net Worth Survey

Yet 70% of wealth managers saw a direct link between clients' philanthropic goals and the desire to integrate this into their investment strategy. This, combined with the question posed above, suggests that private clients' wishes may not be fully met.

<sup>23</sup>[www.uksif.org/cmsfiles/Eurosif\\_UK\\_SRI\\_08.pdf](http://www.uksif.org/cmsfiles/Eurosif_UK_SRI_08.pdf)

There is also the challenge to provide the products that can meet this need adequately too.

For private clients, 55% rated the availability of products and investment options presented by their wealth managers as 'very important' but only 27% of advisors felt the same.

*"This seems to illustrate a wide gulf between what clients want and what wealth managers think they want"*

(Kleinwort Benson et al., 2009).

However, since the credit crunch, clients are more prepared to 'vote with their feet' and switch to asset wealth managers who can provide the service they require. Clients are becoming more vocal in expressing such preferences to their managers, but need to take an increasingly active role in the general education and decision-making process to move SRI and social investing ahead. Our survey suggests that clients' preferences for social investment may well go unobserved and there is an opportunity to ensure there is a fully functioning communication process between clients and fund managers to express and match investment preferences.

#### **4.2.3.2 Environmental, Social and Governance (ESG) elements of SRI**

Three key components of SRI are the ESG impacts of investment decisions. Of these:

- The Governance agenda is advancing. Shareholder value is enhanced by showing effective and robust governance strategies and investors seek this out
- Environmental issues are increasingly measured; the growth in green funds reflects this (there are now over 100 ethical and green funds in the UK)
- Social impact is lagging behind as a component of SRI. Whilst human rights, for example, are considered to be an important component of an investment proposition, in practice it is hard to secure reliable data on production methods at plant or factory level. More subtle aspects of social impact may not feature or be provided to inform an SRI fund manager's investment decisions.

The Companies Act of 2006 obliges companies to make decisions which give due regard for the environmental and social impact of their actions. The corresponding duty on investors to consider the impact of their decisions under these parameters is not yet as developed in mainstream practice (Berry, C. for Fair Pensions (2011)).

The expected Green Investment Bank, to be launched with £3bn of state and private sector assets, will invest in and support green technology. Social Investment will find itself increasingly in competition with environmental investment proposals as the SRI market is approached to support these proposals.

#### 4.2.4 Key recommendations on vehicles for investment fund managers

These investors are ‘finance first’ investors. To attract these investors the sector needs to:

- 1 Develop joint working with champions in the SRI sector and social finance product designers to create products that fit SRI requirements and contain opportunities for social investment, for example through pooled structures, social sub-funds of OEICs<sup>24</sup>
- 2 Create a Special Purpose unit of social investment experts who would bring products to the attention of fund managers and carry out pre-transaction research
- 3 Find ways to link client demand for SRI with client demand for social investment given the likely overlap in the target groups; provide regular information on product availability and developments to fund managers
- 4 Develop products that mitigate risk in social investment by underwriting, or guaranteeing the principal at least; engage SRI investors through this use of ‘tiered financing’ in products
- 5 Determine which products would secure SRI interest in public sector spin-out investment opportunities, given their potential scale, track record, and possible liquidity
- 6 Create pooled social investment products, once there is enough ‘mass in the market’, for example create social sub-funds of an OEIC or investment trust structures
- 7 Map out the number of businesses that could form a viable Social Exchange Traded Fund to track listed social businesses; use it to inform development of Social Stock Exchange
- 8 Encourage greater use of equity in new social enterprises to open up future SRI investment opportunities more readily

### 4.3 Banks – Investment, Private, Retail and Social Banks

#### 4.3.1 Description of different types of banks and relevant terms

Retail, investment, private and the few social banks all have a potential role to play in supporting the social investment agenda. We look at these in more detail after defining each type of bank. Also some banks, such as UK retail banks like Barclays, for example, will fit into several categories. For the purposes of this report, banks are classified as retail banks if they have a high street presence, in spite of their additional categories.

**Retail banks** provide a wide range of personal banking services, geared primarily toward individual and small business customers. Retail banking is usually made available by commercial banks, as well as smaller community banks, focusing their services strictly on consumer markets. The market value of the top five UK retail banks (often called the clearing banks) is £284 billion (February, 2011).

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<sup>24</sup> Open Ended Investment Company

**Investment banks** may underwrite securities issued by their clients and trade, research and sell outstanding securities (such as stocks, bonds and derivatives). An investment bank may also provide other services, such as professional advice, particularly on mergers & acquisitions and private wealth management. Investment banks generally do not take deposits, although some have adopted a Universal bank model, where retail operations sit alongside investment banking activities.

**Private banks** provide exclusive investment-related advisory and execution services for High Net Worth Individuals (HNWIs), from managing investments to tax planning, deposit-taking, providing specialised financing solutions, planning retirement and inter-generational wealth management. Many investment banks have private banking arms (including J P Morgan, UBS) as do retail banks like Royal Bank of Scotland, via Coutts.

**Social, ethical and charitable banks** in the UK collect deposits to invest or lend to ethical, environmental, social or charitable borrowers. The Cooperative bank has a loan book of £8.3 billion, Triodos has its loan book valued at around £570 million whilst Charity Bank has around £50 million lent out to social enterprises and charities. This shows the wide discrepancy in size, business opportunity and capital need across this group of banks.

**Community Development Finance Institutions (CDFIs)**<sup>25</sup> lend money to businesses, social enterprises and individuals who struggle to get finance from high street banks and loan companies. They help deprived communities by offering loans and support at an affordable rate to people who cannot access credit elsewhere. Social banks such as Charity Bank, Triodos and Unity Bank are CDFIs. CDFIs are potential users of the tax relief **Community Interest Tax Relief (CITR)** which is available to investors in CDFIs for on-lending to businesses in deprived communities under strict conditions (see Heaney, V., 2010).

**The Enterprise Finance Guarantee Scheme (EFGS)** is a targeted measure intended to facilitate additional commercial lending to viable Small and Medium sized Enterprises (SMEs) which are unable to obtain a normal commercial loan due to having no or insufficient security. Banks seek this reassurance to take on more risky lending. In theory this guarantees up to 75% of the loan, but interviewees suggested that various administrative and other costs involved reduce this, in practice.

#### 4.3.2 Main findings: action to date, barriers, preferred investment vehicles

##### Are banks already engaged in the social investment sector?

- Some investment banks initially engaged in social investment through Corporate Social Responsibility strategies, out of which formed a more strategic corporate commitment (for example, Deutsche Bank is in the process of creating its own social investment / impact investment fund of funds for on-lending into intermediaries)

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<sup>25</sup> Most social ethical or charitable banks are also CDFIs, but not all CDFI lending can be attributed to banks, as there is non-bank CDFI lending (e.g. from social private equity); total CDFI lending in 2010 was c£200m in the year to March 2010



- Banks interviewed sought a range of investment positions from 'blended' returns to 'finance first', depending on whether using clients' funds or banks' funds
- Retail banks are significant providers of tailored loans at 'marginally sub-market rates' to charities and social enterprises; Retail banks lent £4.3m of capital to CDFIs<sup>26</sup> for on-lending in 2010 (Glavan, H. and Best, I.)
- Some wealth managers of private and investment banks, managing portfolios for Foundations' or HNWIs, seek social investment opportunities as part of their services; they see these two categories of clients as the most likely to want to engage
- Social and charitable banks, most of whom are also CDFIs, are established to provide working capital and asset backed loans to the social and charity sector; their use of CITR has made them able to compete with the Government's Futurebuilders fund and with retail banks in the loan market

#### **What are the barriers to activity? What would help them invest?**

- A few of the social banks are undercapitalised; without further funds they may not be able to expand their loan books; BSB capital and resource support to these banks could be critical, (depending on its terms)
- Investment banks seek greater clarification on the blend of the social and financial returns; the lack of rigour in impact measurement provides them with a reason not to engage
- Scale and liquidity issues prevent some from engagement unless clients (typically HNWIs) specifically request social investment products; additionally, there is a lack of robust mechanisms to identify client demand in general
- No clear mechanism to identify client interest in social investment;
- Products generally do not come on to their radar
- Public sector spin-out investment opportunities are of interest but are viewed as risky; banks seek government underwriting to mitigate risk
- Role of an individual who becomes "champion of social investment" within a bank has been critical to taking it forward within an institution
- One possible barrier now removed: reduction in government loan funds could generate increased demand for loans from retail and social banks

#### **What type of investment vehicle would they favour and on what conditions?**

- Products that meet the likely client group's needs e.g. mission related Common Investment Fund (CIF) if enough securities to place within it (for foundation clients)
- Private banks want to see products that use tax incentives attached to investment vehicles to help attract their HNWI clients into the sector
- Investment banks will be driven by client demand but favour investing into funds where expertise lies in managing the investments; they are not usually seeking direct investments; private bank clients might 'execute' only (not advise) on individual social investments for interested HNWI clients
- An underwritten fund for CDFIs, currently in development, could attract a range of banking investors if their loans are guaranteed and subordinated debt is provided

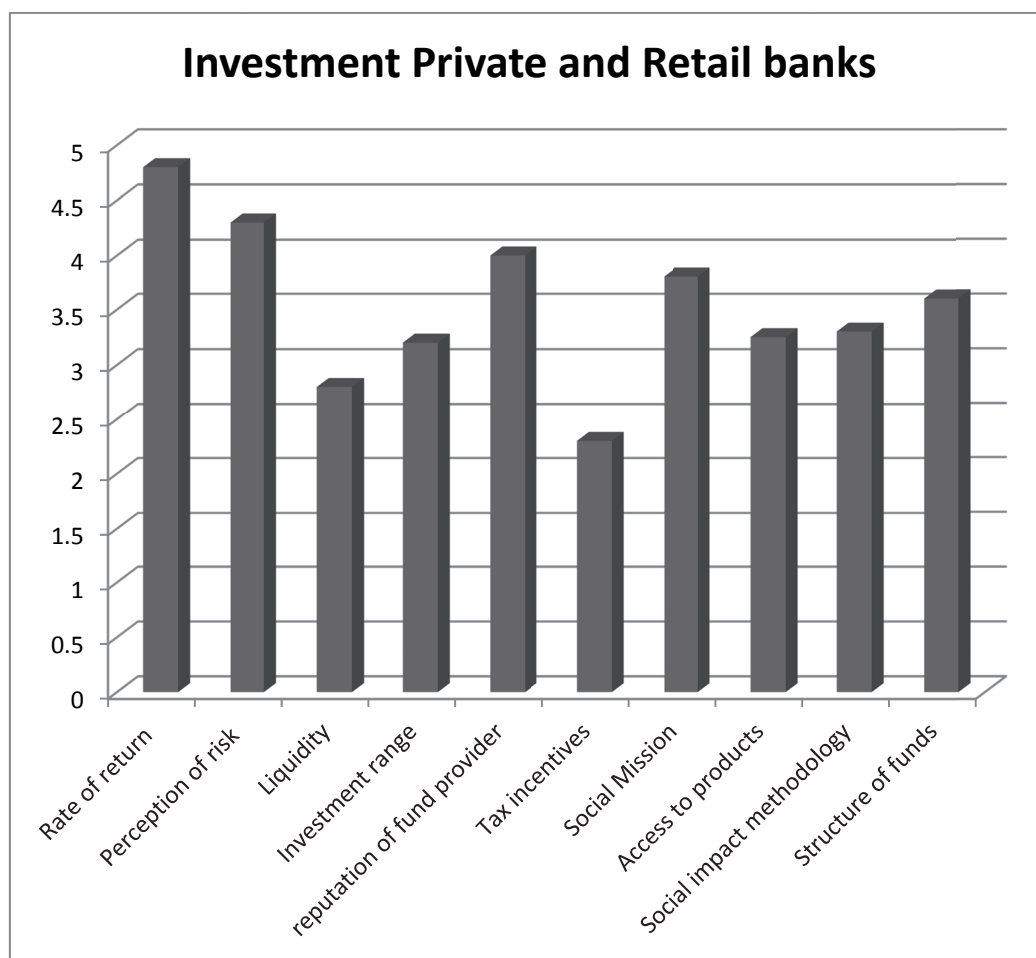
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<sup>26</sup> Community Development Finance Institution

- Public sector service pooled funds are potentially interesting to Foundation clients; retail banks seek high levels of risk mitigation to engage in such investment – most are now considering their position towards public sector spin-out investment

Chart 4.3.2 gives a snapshot of the priorities that these groups of banks attached to investment criteria. Again, this is based on a very small sample, (7) using average scores, so is merely indicative of trends. We see the same importance of risk adjusted rates of return, the reputation of the fund originator and the investment range which can have high thresholds - up to £35m for one investment bank; this was less important for retail and private banks. Liquidity is also not such a large issue for banks which offer debt for fixed terms, but was more significant for investment banks considering whether to invest clients' money into social investment.

**Chart 4.3.2: Investment, Private and Retail banks' average rankings of vehicle features**



Source: interviews; maximum average score per feature: 5

### **4.3.3 Specific issues for different types of banks**

#### **Routes for banks to engage in social investment**

There are two potential routes to banks' engagement in social investment. One is where banks use their own resources as an investor to test the social investment market for further development within the bank. The second is generated by client demand. These are dealt with in different ways across different types of banking institutions.

#### **Investment banks**

Where investment banks have committed their own resources to social investment, some have originated from a CSR function. Deutsche Bank and J.P. Morgan, for example, have now established, or are in the process of establishing social finance strategies or units within their organisations. Both have already invested in social financial intermediaries rather than investing directly in an enterprise or activity.

A key feature of these initiatives has been the role of a senior champion to drive the agenda through to the top of the organisation. Without this, social investment usually remains marginalised and is seen as a philanthropic tag-on to business. The creation of an integrated social investment strategy within an investment bank helps to prove the business case for such investment and does much to integrate the concept into mainstream banking operations. Banks, in general, looking to introduce such funds are likely to seek returns in the range of 7% across a portfolio of investments, investing typically £500,000 per investment, although current activity falls short of this.

#### **- Internal drive for social investment and the link with CSR**

Where social investment has formed out of a bank's CSR initiative, there is frequently an associated commitment to provide other in-kind support, (via the corporate volunteering scheme as an example), which is seen as valuable. The in-house expertise, the pro-bono resources for mentoring and business advice could help to address a significant gap in social enterprise capacity (Cabinet Office, 2011, Shanmugalingam C., 2011).

Banks which are considering creating social investment funds are keen to attract investors who are willing to underwrite or mitigate the risk of such propositions, as they are perceived to be of high risk. This search for what is effectively a form of credit enhancement has been a common theme expressed by investors throughout the research. Most expect the government, BSB or charitable foundations to be the provider of such subordinated funding. The banks interviewed were interested and informed on the key public policy issues which might affect social investment requirements.

#### **- Client driven demand for social investment**

All banks interviewed thought that charitable foundations and HNWIs would be the two categories of clients most likely to drive forward any request for social investment. Some actively anticipate this demand, while others see little

evidence that such demand exists. They were open to designing bespoke funds or products if this was required to 'attract and hold on' to these valuable clients.

### **Private banks**

One private wealth manager stated that:

*'Social investment comprises 1% of the deal flow but 90% of the conversation'.*

Some private banks have worked to introduce their HNWI clients, as potential business angels, to social ventures looking to raise capital. Whilst the starting point for this has been, and still remains, predominantly philanthropic, investment in social enterprises is increasingly attractive as an alternative 'third pot' for HNWI's financial planning, after donations and traditional investments are allocated.

To this end, certain banks interviewed are considering creating structured products that meet their clients' needs more precisely. Wealth managers identify slowly rising demand for these products but the relatively low number of quality investment opportunities to date has been an obstacle.

In order to cover transaction costs and elicit sufficient demand, one bank felt a structured product which would protect the principal and offer some upside would be optimal. The model could be something like a fixed rate five year bond, with a return of say 5%, in which 80% would be invested in a cash equivalent deposit account to generate the returns, allowing 20% to be used as investment in the enterprise. This type of structured product was seen as preferable by many investors interviewed for this research and is described in Section 7.4.4, under Products. Products that incorporate tax relief schemes, such as the Enterprise Investment Scheme or Venture Capital Trust, are attractive to private banks' clients. Individuals in the Netherlands for example, can offset up to €55,000 per year against their annual wealth tax liability for investment in specified funds including green business and social, cultural and seed capital funds. (Heaney, V., 2010).

### **Retail banks**

Social Enterprise Coalition (SEC) research in 2009 showed that 90% of social enterprises sought funding, but only 10% approached their banks to meet this need. The majority sought grant related funding. There is therefore an identified market for those enterprises that are profitable enough to repay a loan, but access to this capital needs to be made easier. One retail bank described its scheme to improve access to finance by training business development staff across the country in the specific requirements of social sector organisations.

#### **- Providers of tailored debt to social enterprises and charities**

Most retail banks offer 'tailored debt' to social enterprises, charities, and other types of social organisations. These banks seem now to work more smoothly with the government funded Social Investment Business (SIB), which seeks to support enterprises with loan requests which banks have declined. In fact, there has been an opportunity to do more in collaboration between SIB and retail banks.

The Social Investment Business (SIB) reckoned that leveraging or co-funding could double the available investment to around £800m, based on the £400m of government funds available. (Telegraph, 23<sup>rd</sup> September 2009). It has not been possible to determine precisely the total retail bank lending figures to charities and social enterprises to assess progress since 2009 and therefore to judge the extent to which this target has been matched. RBS, reported to be the largest of the lenders to charities, has relationships with 43% of the top 10,000 charities<sup>27</sup>.

Retail banks seek to provide a return at a rate which is 'favourable' to charities and social enterprises, providing loans on 'sub-commercial terms'. Those consulted for this research offer their best terms on secured loans, for obvious reasons. Retail banks have extensive networks and are able to provide access to capital to many in a way that the private and investment banks cannot. Their lending strategies are leaning towards 'finance first' investments but they aim to allow for some trade-off between financial return and social return.

Retail banks have a range of loan products that they offer to the social sector, but they are careful about developing this too quickly. Those interviewed expressed caution, given the higher risks and likely low returns associated with social investment, at introducing retail products at this stage. (See Chapter 7 for more detail on possible products). The start-up market is perceived to be even more risky, despite the Enterprise Finance Guarantee Scheme which ensures banks receive back from the government up to 75% of any loan defaulted on (under certain circumstances).

### **Bank lending to Community Development Finance Institutions**

Since 2009, retail banks have a greater guarantee on perceived 'risky' loans made to Community Development Finance Institutions (CDFI) through the Enterprise Finance Guarantee Scheme. However, these guarantee extensions have not seemingly affected bank lending to CDFIs, which amounted to a mere £4.3m in 2010 (CDFA, Inside Out, 2010). It appears that the message of these guarantees on this type of lending may not have been effectively disseminated and could be re-presented in a concerted effort to engage banks in this lending.

CDFIs are in need of two types of investment – firstly, to develop their own capacity and growth, and secondly for building up the loan books. As CDFI lending is perceived as highly risky, it has more difficulties in attracting investors. One way to assuage this risk is by establishing a vehicle for raising investment which then lends to CDFIs as a wholesaler. That way, individual investors are not exposed to risks inherent in any individual CDFI but rather share the risk across many CDFIs. The Community Development Finance Association is currently developing such a wholesale fund, using European funding as the junior investor and offering the Community Interest Tax Relief (CITR) to institutional investors. Initially capitalised at around £25m, the fund will lend to CDFIs at competitive rates. Currently, the CITR scheme has considerable restrictions in the terms and timing of on-lending and the sectors into which it can lend. The two areas which are excluded are social housing and personal lending – both of which are areas of activity for social enterprises (Heaney, V., 2010).

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<sup>27</sup>Established through interview

- **Public sector service investment**

Retail banks were well informed on the public sector policy issues which might affect their lending requests. Most banks were weighing up their options and were waiting to assess the role that the Big Society Bank might play in underwriting some of the risk. Ironically, this is partly to be determined by the terms on which finance from the four large retail banks is provided to the Big Society Bank under "Project Merlin". This is a wide reaching deal between the government and the UK's four biggest banks. As part of this agreement, £200m of finance will be invested in to the Big Society Bank, although at the time of writing, the terms of this finance have not been clarified or made public. The retail banks are interested in possibly forming partnerships with charitable foundations as they seek to collaborate on investments with organisations having differentiated risk profiles. As stated in Section 4.5, the Foundations' appetite for such a role is limited, and will depend on the individual proposition.

- **Impact measurement**

Issues around measurement of social impact and comparability of propositions continue to trouble almost all potential investors interviewed. The retail bank sector is perhaps less demanding than other sectors in seeking categorical benchmarks but it still sees the creation of a set of viable social impact metrics as a critical way of moving the sector forward and justifying the 'opportunity cost' from any investment's reduced financial returns. The issue of appropriate social impact measurement methodology to meet investors' needs is discussed in more detail in Chapter 7.

- **Social and charitable banks**

These banks are designed to lend to social enterprises, community groups, charities and organisations which aim to make positive social or environmental impact. As their depositors are prepared to accept blended returns on their accounts, so they are able to provide capital to the social sector, often at below-market cost. Charity Bank has the unusual status of a charity offering equity. Foundations and institutions are investors into Charity Bank and trading in these shares is carried out on a 'matched bargain' basis (as with much social share capital – see Section 7.4). Charity Bank seeks further capital to develop products and to grow its balance sheet to £200m in the next 3 -5 years, with BSB being a likely provider of resource support. Charity Bank offers blended returns to its investors and depositors. It actively seeks to use the CITR to encourage deposits and provide cheaper capital to its borrowers.

Triodos Bank has more of a 'finance first' profile and has made use of the Enterprise Investment Scheme to provide tax relief to its individual customers. The Dutch based institution offers investors depositor 'receipts' into the bank, and these are held by a variety of institutional investors, including Dutch pension funds. Again, these are not listed on any share index and are traded on a matched

bargain basis. No Triodos 'shareholder' may hold more than just under 10% of the total number of "depository receipts" in issue to prevent any one shareholder exerting undue influence over Triodos Bank's mission and objectives. Triodos is fully commercial and has increased its UK loan book by 26% in 2010 to £312m. It seeks to grow this to nearer £600m by 2014 (Joy, I., 2011). It has repeatedly successfully raised capital on the financial markets.

### **Community Investment Tax Relief (CITR) and social and charitable banks**

Most of these social/ charitable banks are also CDFIs and would be entitled to draw down CITR, although not all do so. Charity Bank is established as a CDFI and is entitled to CITR on its lending in deprived or disadvantaged communities. Charity Bank had over £24m of CITR funds lent out in 2010, but has a waiting list of investors wanting to deposit a further £10m (Heaney V., 2010). The constraint lies in the onward lending restrictions – the Community Development Finance Institution must on lend 25%, 50% and 75% of its funds by the first, second and third years, respectively, after accreditation.

Furthermore, as discussed above, CITR does not allow for investments in social housing and personal lending. The extension of the CITR scheme for all CDFIs and the announcement of the regional growth fund's allocation of £450m spread over the 66 CDFIs in the recent Budget helps in the short-term. But CDFIs seek capital to maintain sustainability – existing sources of capital are closed with the Regional Development Agencies' (RDAs) demise. RDAs provided £15m to CDFIs in 2010, (Inside Out, CDFI, 2011). It is not clear if the Local Economic Partnerships will replace any of this funding. The social banks' position is well documented in the latest report from NPC (Joy, I, 2011). Less bureaucracy, a wider range of sectors (to include social housing and personal lending<sup>28</sup>) and more investable enterprises to lend to could improve the take up of CITR greatly, and thereby the financial robustness of its core users. Unity Bank and Cooperative Bank are also active social bankers, again with CDFI status. The issues regarding the restrictive use of CITR apply to these banks as well.

#### **- Social ethical and charitable banks as Product Designers and Innovators**

These banks have a track record of being innovative in finding new ways to attract investors to the social sector - although such innovations are not always successful. Triodos launched its Opportunities Fund in 2008, with £3m from its own resources, but found the number of investable, scale-able propositions offering equity were too few. The fund closed in 2010, after over 280 applications were received and only one investment was made.

Charity Bank and Investing for Good are developing a Medium Term Note programme which offers charities a way to raise unrestricted debt finance at scale. This provides much needed stability to the financial planning of charities. The target investors are SRI

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<sup>28</sup>Finance for business loans is accepted, and for individuals establishing businesses, but microfinance loans for personal use are ineligible under CITR

fund managers, wealth managers and their clients and private Foundations. Details of this product in development are given in the Annex.

#### **4.3.4 Key recommendations for attracting different types of banks into the sector**

1. Consider creating structured products that mitigate risk and make use of tax incentives to encourage private clients to invest in social enterprise vehicles
2. Consider the creation of a 'Mission Related Common Investment Fund', recognising both the investment requirements of the wealth managers of Foundations (within investment banks), and Foundations' own requirements for direct investment may differ (see 4.5)
3. Send out clearer messages to the retail banks that CDFI lending guarantee is widened; engage with banks to help provide core and loan finance to CDFIs
4. Revise the restrictions on CITR lending to include personal finance and social housing; ease the bureaucratic procedures to maximise use of CITR investment opportunities
5. Use EU and other governmental budgets as underwriting and risk-mitigation devices for investment funds; use this approach to lever in commercial finance to CDFIs and to develop a public sector pool of funds
6. Ensure that banks provide greater financial data regarding lending to this sector to determine the effects of different policy and tax changes
7. Integrate work on ESG measurement with work on social impact measurement
8. Find the champions within the banking structures; build on experience of other banks who have taken a lead on this; maximise use of bank's in-house support and expertise for the sector's growth
9. Provide training seminars to improve knowledge of social investment opportunities and present these to a range of wealth managers at banks
10. Make greater and creative use of tax vehicles to provide incentives for HNWLs to engage in social enterprise

#### **4.4 Pension funds**

##### **4.4.1 Description of pension funds; size of class**

Pension funds are common asset pools which are designed to generate stable growth over the long term, and provide pensions for employees when they reach the end of their working years and commence retirement. Pension funds are commonly run by a financial intermediary for the company and its employees, although some larger organisations operate their pension funds in-house. In 2009, the UK has \$2.5trillion of



assets under management in pension funds, 9% of the world's total, a sum larger than the UK's GDP<sup>29</sup>.

Whilst pension fund trustees' fiduciary duty allows them room to consider a broader range of propositions than just those which maximize profit, this duty still requires that investments are expected to generate at least market-level returns. On this basis, there are a few individual cases of pension funds engaged in 'finance first' social investment and these throw light on possible ways to extend their role in social investment. The data set of pension funds is too small to draw up a graph representing their findings, but the key points around product design are highlighted below.

#### **4.4.2 Main findings: action to date, barriers, preferred investment vehicles**

##### **Are pension funds already engaged in this sector?**

- Isolated cases of 'finance First' social investments made by pension funds (engagement in 'finance first' social impact investment beyond the UK exist but was not covered by this report)
- Role of a champion is key to take such an investment forward and a direct approach from product providers with investment fund manager
- Investments uncovered by this research project were typically made into a social venture fund to gain the size of investment required (£10m+)
- Pension funds had engaged in finance first social investment where they had confidence in the reputation and track record of the fund manager

##### **What are the barriers to activity? What would help them invest?**

- Social Investment must fit within a portfolio allocation; best fit is into private equity allocation, if available (but is illiquid)
- Investment must meet commercial financial hurdles, (c7%+ on average) taking account of risk level – 'impact first' social investment propositions would fail the risk adjusted rates of return required
- Due diligence is costly in proportion to an investment size of less than £10m
- Routes to market for social investment are underdeveloped; need to engage with SRI consultants and fund managers directly as the social product market develops

#### **4.4.3 Specific Issues for different types of pension funds:**

##### **4.4.3.1 Fiduciary duty and social investment**

As a category of investors, pension funds are often thought to be the "toughest nut to crack" to engagement in social investing. Much is made of their fiduciary duties which are assumed to mean they are obligated to maximise financial returns to pension fund holders. In fact, there are challenges to this perspective: two key duties underpin the

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<sup>29</sup>TheCityUK estimates based on Watson Wyatt, OECD, Insurance Information Institute, Investment Company Institute, SwissRe, CEA data; (see reference list Fund Management 2010)

fiduciary obligation – the duty of loyalty to the clients' wishes and the duty of prudence to act wisely

*"In the manner which he/she considers to be in the best interest of the client, regardless of personal beliefs or preferences."*

(Berry et al., 2001)

This may allow room for a wider consideration of the environmental and social consequences of an investment. However, the obligation on companies, under the Companies Act 2006, to show 'due regard for the environmental and social impact of their actions' is not yet matched by a clear corresponding duty on investment managers to consider the impact of their investment decision (Berry, C., Fair Pensions, 2011). This would require a greater connection between fund managers and beneficiaries' wishes, and for fund Trustees to ensure that investment decisions were thoroughly scrutinised for these considerations.

There appears to be little room for 'impact first' investment propositions in pension fund management in the foreseeable future. Asset locked vehicles, however successful, will struggle to fit into a portfolio here as the constraint on returns restricts the investment's capacity to compensate for other losses within the portfolio. The sector needs to prepare the ground for pension funds to engage in social investment opportunities once these are able to offer improved risk adjusted return rates.

The track record of financially viable social enterprises is not yet fully established but, if market rate returns can be generated from social investment, there is a real opportunity to bring scale to the sector by developing funds of sufficient size to attract investments from pension funds.

#### **4.4.3.2 Finding the right allocation**

Interviews suggested that a typical pension fund might have the following allocations in to which to make investments.

**Table 4.4.3.2: Table showing a typical portfolio of a pension fund**

Category of Investment	Guide to percentage allocation
Public Equity	50%+
Real Estate	c10%
Private Equity	part of remaining 30%
Hedge Funds	part of remaining 30%
Commodities	part of remaining 30%
Sovereign Bonds	c 10%

Note: this is a guide, based on interviews, and not all pension funds will hold this portfolio structure

The most appropriate allocation for a social investment would be private equity if a proposition can be shown to be 'finance first', generating risk adjusted rates of return which are commensurate with the overall portfolio strategy (c 7% returns across the portfolio, according to our sample survey). Interviewed pension fund managers suggested that the preferred investment would be £10m+ minimum, with an ideal investment size nearer £35-40m. Unlike SRI fund managers, our sample of pension funds interviewed tended not to invest via Open Ended Investment Companies (OEICs) or other types of funds and made little use of corporate bonds. However, this might not reflect the sector generally.

If a pension fund is cash positive<sup>30</sup>, it may not have to focus so tightly on liquidity. In theory, this could be advantageous to social enterprises which traditionally offer lower liquidity than other investments.

#### **4.4.3.3 Products that alter the risk adjusted rate of return**

Pension funds would normally require risk adjusted rates of return which are prohibitively high for most social investment opportunities in the UK to achieve, to date. However, other impact investment sectors (e.g. microfinance, environment, social housing) and in other regions (particularly in emerging markets) have produced market compatible returns (O'Donohoe, 2010). TIAA-CREF, one of the largest US Pension funds, committed more than \$600 million to Impact Investments across asset classes (from cash to debt to private equity) which comply with fiduciary responsibility regulations.

Investment propositions which have a degree of underwriting, guarantee or other form of subsidy to reduce the risk are of potential interest to pension fund managers (see Section 7 on Products). Social investment vehicles which have tiered structures, in which different investors shoulder different levels of risk, help pension fund managers meet

<sup>30</sup> If a pension fund is cash positive, it pays out less than it receives in contributions at a given point in time

their fiduciary responsibilities whilst achieving various impact targets. Some pension funds have invested in the International Finance Fund for Immunisation (IFFIm) which has this structure, using institutional funds and donor grants as the bottom tier of financing. It provides 'prime rate returns' to institutional investors (Bridges, Parthenon and GIIN, 2009); (see case study on IFFIm in Section 7.3.2).

In fact, a selected few pension funds have invested in UK 'finance First' social investments (for example, the USS Pension Fund invested in Bridges Social Ventures Fund 1). In this case, the investment proposition is attractive because the financial demands are met. The fact that Bridges Venture fund has also measured its social impact such that *'each £1 invested by Bridges Ventures is leveraging an additional £2.10 into our target areas'* improves the proposition, but is not in itself the primary concern. Pension funds are however, limited in their choice of such UK investments by the short supply of investable 'finance first' propositions.

#### **Taking the investment proposition to the pension fund**

Pension funds need to be informed about financially viable social purpose investment opportunities. Currently, those interviewed said that little information on such opportunities reached them. The route from financial consultants is not developed, and direct marketing material is not created, or does not reach them. This underscores the need for the social investment sector as a whole to develop a promotion and information strategy to ensure different types of investors have better access to products. Whilst the social sector has not yet produced retail social investment products, it is important that once it does so, it employs all available marketing channels fully. Without good access routes, it is not possible to know if the level of engagement is under-represented by the lack of knowledge, interest or other factors. The new products under development targeted at sophisticated investors should be taken to pension fund managers, and product designers should search out potentially interested or targeted investors, designing products with their key requirements in mind. Language and messaging is critical; even use of the term 'social investment' was said to send signals of non-financial viability to some pension fund managers.

#### **4.4.4 Key recommendations on vehicles for pension funds**

1. Create opportunities for larger investments via pooled funds (c£35m+)
2. Structure products to mitigate highest risk
3. Create large scale investment opportunities, e.g. public sector pooled funds structured around Limited Partnership if not needing high liquidity
4. Use local element of an investment opportunity – 'finance first' social initiatives which meet local needs can be attractive to pension fund managers
5. Work towards bringing social investment products to the attention of the pension fund managers as they offer nearer market level return

## **4.5 Charitable Foundations**

### **4.5.1 Description of charitable foundations**

Charitable trusts and foundations, referred to as foundations in this report are legally categorized as non-profit organisations which either donate funds and support to other organisations, or provide the source of funding for its own charitable purposes. Though numerous historical foundations no longer have any direct link with a family, individual or company from which their charitable endowment originated, a significant number of the foundations which are most active in the social investment 'space' have been recently created by 'living donors'. They remain the key decision makers in their foundations' activities. This blurs the boundaries between an 'institutional investor and a private High Net Worth Individual.

#### **Funding strategies for charitable foundations**

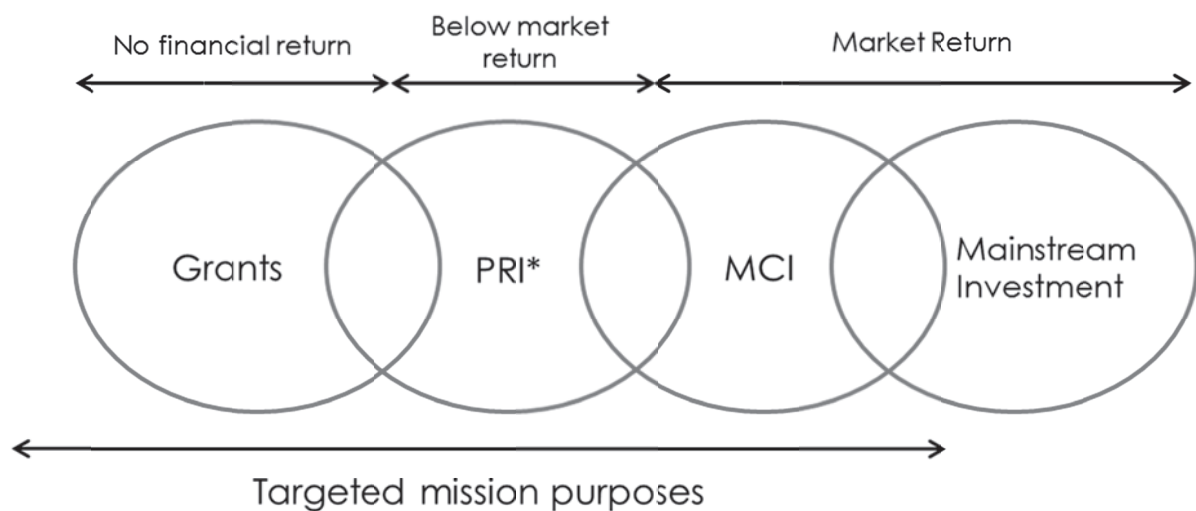
Charitable foundations have a potentially unique position amongst institutional investors. They can have up to four separate financial strategies, which could all work together to deliver more towards their mission. Firstly, there is the traditional' strategy of maximising profit from their endowment investments. This provides the income for their grants, their second strategy, and for their 'Programme Related Investments (PRI), their third strategy, out of which they may make non-market rate loans or investments. The fourth strategy, Mission Connected Investment (MCI), sits between these forms of finance, and allows a portion from the endowment portfolio to be invested in activities which support their mission.

By investing, rather than donating in this way, foundations may recycle a small proportion of funds for further use and tailor their grant strategy to support those organisations that cannot receive investment.

These options create a unique set of possibilities for taking forward social investment as well as for enhancing their mission. There is clearly overlap between these different funding strategies, and PRI and MCI are sometimes blended to provide one investment package to an organisation. There are important accounting issues involved in allocating social investment to the Foundation's appropriate investment strategy (covered by the Charitable Commission 14 (CC 14) guidelines which are currently under revision). Social investment will be allocated across PRI and MCI variously across foundations.

Chart 4.5.1 shows how these combined funding pots can fit together in an overall financial strategy of a charitable trust. There are overlaps at each point.

Chart 4.5.1: Range of investment strategies open to charitable foundations



*\*PRI (Programme Related Investment) – Investment by foundations primarily for mission purposes which generates returns that are typically below market levels.*

Source: Mission Possible, NEF, 2008

#### 4.5.2 Main findings: action to date, barriers, preferred investment vehicles

##### Are they doing anything already?

- A small group of larger foundations engaged in social investment have between them around £50m budget allocated (from PRI and MCI)
- The majority of foundations are not engaged in social investment; they would need significant information and reassurance on their fiduciary duties to become so
- The pioneering foundations have staff with considerable knowledge of the field: to date, they manage their own social investments in-house
- These foundations both invest directly into enterprises and invest via funds or intermediaries
- They have invested into a combination of asset locked and non-asset locked enterprises

##### What are the barriers to activity? What would help them invest?

- One or more champions required to advise and drive forward social investment with the Board of Trustees is a key factor
- Perception of restrictive fiduciary duty is seen as preventative; information for trustees needed on how social investment can be used effectively, within their fiduciary duties, to enhance their grant and endowment strategies
- Wide variation in level of trustees' financial expertise and their time influences the level of engagement

- More information on the historic levels of risks and rates of return generated in traditional markets to provide benchmarks for the real risks of social investment
- Development of in-house expertise on social investment to direct social investment
- Support networks for charitable foundations engaging in social investment to consider suitable products and policies (already in development)

#### **What type of investments vehicles would Foundations favour? And on what conditions?**

- There is some appetite to investigate tailor-made products e.g. mission related Common Investment Funds (with external support, as required)
- Foundations have limited appetite to take subordinated debt merely to provide commercial investors with market returns, but there is scope for forming investment partnerships with differentiated risk levels, to act as early adopters to test new concepts (e.g. the Social Impact Bond pilot)
- Investments need the potential to generate scale and must have clear exit strategies to be attractive to Foundations
- Revisions to CC14 could help clarify uncertainty which prevents trustees taking risks on investments
- Effective measurement of social impact is critical to foundations' investment decisions
- Clear transparent structures and governance of investment funds were vital

#### **4.5.3 Specific issues for foundations**

Charitable foundations have been playing a vital underpinning role in the development of the social sector for centuries. Through the income generated on the endowments invested, the top 300 Foundations have supported various causes through grants to the tune of c£2.7 billion per annum in the UK (Charity Market Monitor, 2008). The entire charitable sector has assets under management valued at £77 billion<sup>31</sup>.

##### **The financial strategies of charitable foundations**

The charitable foundations which were interviewed for this report were, to varying degrees, leaders in their sector in engaging in social investment through use of their Programme Related Investment and Mission Connected Investment strategies. We realise that there are other charitable foundations who are also active in this field but whom we were not able to interview, as we sought samples from each investor type.

The report by New Economics Foundation in 2008 'Mission Possible' (Nissan, S. and Bolton, M.) researched in depth the practices, barriers and expectations of the charitable sector when engaging in MCI. It highlighted the following barriers to greater take up of MCI:

- It requires trustees to be more engaged in choosing investments than most currently are

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<sup>31</sup> Charity Commission website

<http://www.charityCommission.gov.uk/showcharity/registerofcharities/registerhomepage.aspx?&=&>

- It takes more time and is more resource-intensive than conventional investment practice
- It requires specialist advice, which is currently in relatively short supply

*"Most foundation trustees aren't looking at alternative forms of investment," "They're just trying to give away the money they make. More boards would consider the idea if they had the time and expertise to examine it in detail"*

David Emerson, Chief Executive of Charities Aid Foundation<sup>32</sup>

However, since this 2008 report was written, the 'pioneers' have responded by creating in-house expertise and a number have already made social investments such as into Social Impact Bonds (SIBs), and into social venture funds. This area is likely to grow slowly but steadily, if well supported with suitably designed products, strong impact measurement methodology and clear understanding of the foundations' investment preferences. In general, however, these points raised by the NEF report above remain in need of addressing, if foundations are going to help develop the sector through their investments. We therefore recommend (in Chapter 10) a range of information and advisory packages be developed to encourage trustees to explore MCI and PRI more fully. We also see this would be helpful in integrating the range of investment strategies with their appointments to boards, investment advisory processes and their mission objectives.

#### **Charitable foundations' rankings of vehicle features**

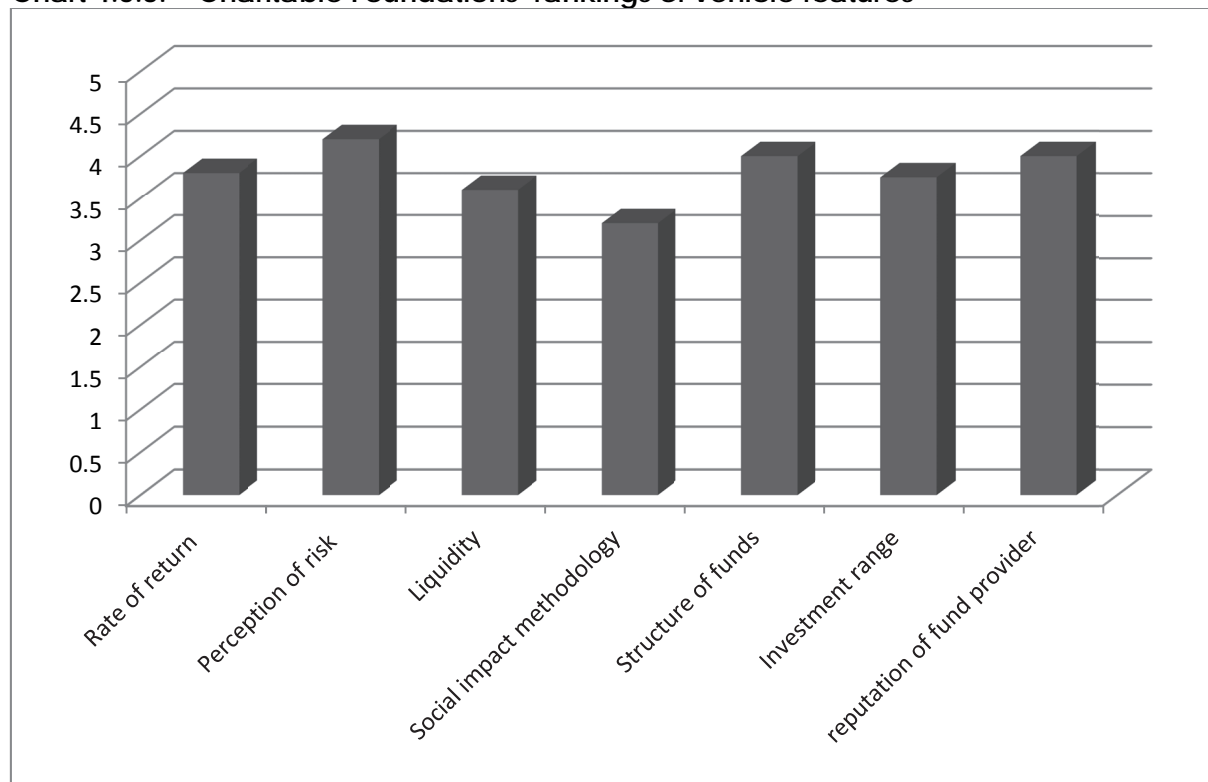
Chart 4.5.3 provides a snapshot of charitable foundations' views on the importance of different features of an investment vehicle. These are based on average scores across the sample group of questionnaires. Again, it is merely indicative of the issues of importance. However, this highlighted the importance charitable foundations attached to different aspects of an investment proposition. These do not differ widely from other investors, as seen in this section. Liquidity here is high reflecting the foundations' need for an exit strategy – if their money is to be recycled, it needs to be able to be released. Although charitable foundations give a high score to the 'structure of funds', in interviews they emphasised that the important issues in the structure were that it was open., transparent, well managed and not international (as yet).

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<sup>32</sup>Third Sector, 14 April 2009



**Chart 4.5.3: Charitable Foundations' rankings of vehicle features**



Source: interviews; maximum average score per feature: 5

### **Rates of return and key investment criteria for Mission Connected Investment**

Foundations interviewed were asked about the risk adjusted rates of return they would seek from social investment. Most would aim to regain their capital or 'lose it very slowly'. Foundations were prepared to accept a lower risk adjusted rate of return than would be sought under a mainstream investment if this also promoted their mission. With no return above initial capital, this would mean a loss of real value over time. There is a willingness to take high risks, but they need to be calculated and assessed according to the extent to which they enhance their mission. One aim of using investment rather than grants is to recycle capital for further investments thus achieving more from their overall financial strategies.

Interviews with foundations revealed that, whilst the expected rate of return on investment was judged as very important, (taking account of risk), it may not be the deciding factor in making an investment. Foundations interviewed were prepared to consider a wide range of expected return rates for their mission related investing, from -100% (as in grants, which would then be accounted as PRI, if this rate is anticipated in advance) up to c7% (see Section 7.1.2 for all investors' expected rates of return).

One element of risk is the lack of liquidity that many social investments might offer – thus locking in finance for long periods, even up to 10 years in social venture funds. One foundation preferred an exit strategy of nearer 7 years so that money could be recycled more quickly. A weak exit strategy, if accompanied by no real opportunity to scale up the activity over time, would be a less appealing investment proposition.

### **Innovative use of combined funding pots**

There is potential for a trust to enhance its mission considerably by integrating its resources and skills from both grant and investment teams. The skills of grant teams, particularly in impact generation and measurement, could be combined with the investment skills of risk, return, asset management and capital costs, and brought together under one organisational strategy. For example, a charity could use its funds from MCI allocation to make a social investment. If the investee would have to pay too high a commercial return to reflect the level of risk, then the Foundation could use its grant funds, which would be given at -100% return rate, to absorb this risk and fill the gap. Overall, the risk to the Trust is no more than it would have been if it had used only grant funding to support the initiative. Also, the investment *may* return some or all of its outlay. The foundation is then able to recycle the money to support other mission related initiatives. The Gates Foundation adopts this mixed approach effectively, using the corporate tools of municipal bonds via MCI and credit guarantees from its grant funds to support the development of Charter Schools.

### **The role of tax incentives**

The US tax laws incentivise foundations towards an active strategy around PRI. The laws require US charitable foundations to spend at least 5% of their endowment allocation each year in PRI (grants) in order to secure the tax exemptions on their core investment income. Movements such as More for Mission aim to push more foundations to invest their core 95% into mission investing (More for Mission Investing, 2008).

The UK charitable foundations are tax exempt on capital gains tax, and VAT exempt on trading certain collective SRI investments, but are subject to tax on dividend income from UK equities. Otherwise there are few fiscal incentives provided to encourage UK Foundations to invest in any particular way. HNWI's who have created or invested into a foundation may then lose any tax benefits from the use of those funds.

**Table 4.5.3: Examples of charitable foundations that have established Social Investment funds**

Trust	Identified current social investment fund size (£ millions)	Date established	Value of investments made to date (£ millions)
Esmée Fairbairn	20	2008	14 <sup>(1)</sup>
CAF Venturesome	10 (current)	2002	22
Lankelly Chase	5	2009	1.38
Panahpur	6 <sup>3</sup>	2010	1.2 <sup>(2)</sup>
Sainsbury Family Charitable Trusts	Not ring fenced; depends on Trust within the SFCT group	n/a	>£1m

Sources: gained from interviews with charitable foundations and from their annual reports, where appropriate

Note: This is a snapshot of known funds and is by no means exhaustive; new funds may be emerging all the time; 15 UK trusts invested in the Social Impact Bond Pilot, so there is possibly more activity than may be ring fenced in MCI budgets

(1): £9m drawn down; £5m more allocated; also some double counting as c £2m of Esmée Fairbairn funds are invested in CAF Venturesome

(2) £1.m committed, not yet spent

(3) Panahpur is seeking to use 100% of its £6m endowments for social investment

UK charities themselves (rather than foundations) are also increasingly interested in combining their programme related activities with social investment to deliver on their missions. Oxfam GB, for example, have established an Enterprise Development Programme to support community businesses globally; it has raised £3.2m of its targeted £6m, and has committed £2.5m into various start-up businesses in agriculture, micro-finance and supply chain development<sup>33</sup>.

### Impact of Charity Commission 14 guideline revisions

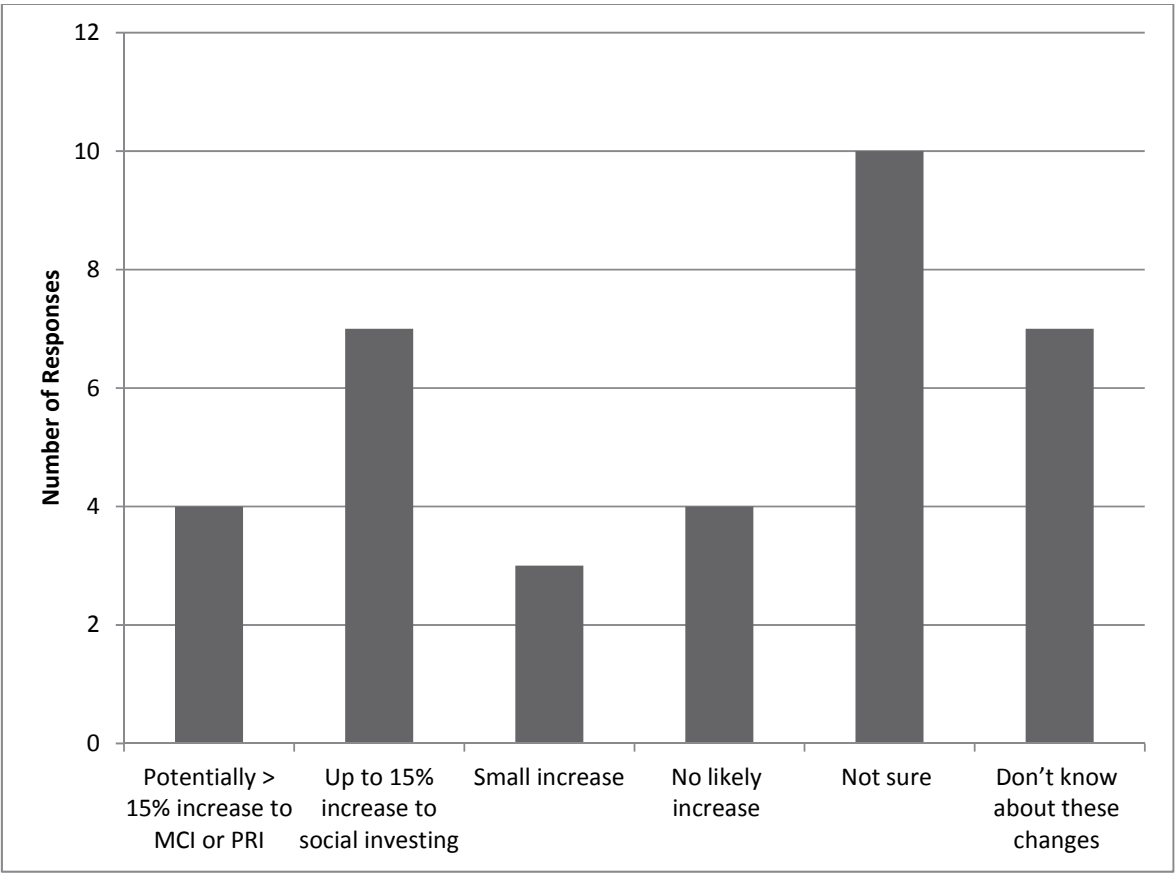
Revisions to Charity Commission Regulation 14, (CC14), due imminently, are expected to bring together guidance on the whole spectrum of investments open to charitable foundations. However, it is likely that accounting regulations will still require PRIs to be recorded on foundation balance sheets separately from 'mainstream investments' and PRIs will also be subject to different valuation accounting rules. The CC14 revisions are important in throwing light on what constitutes a MCI and when it can be considered a blended investment with a PRI.

If, following the changes to CC14, foundations choose to engage in social investment through PRI or through MCI, but do not make their own social investment decisions, then other institutional investors' advising the foundations may need to become more informed and engaged in social investing. Currently, our research suggests that social investment decisions are dealt with in-house and foundations' engagement in this, to date, has had little influence on external financial institutions, such as on their wealth managers.

<sup>33</sup> <https://www.oxfam.org.uk/donate/edp/index.html>

Over time, it is possible that external investment fund managers advising foundations, within banks or investment houses, will develop knowledge of social investment products to offer their clients. For this reason, it is important to determine the perspectives of other types of investors (apart from charitable foundations), of the effect of CC14 revisions on foundations' likelihood to seek out social investment. This is depicted in Chart 4.5.3:

**Chart 4.5.3: How will updates to CC14 affect your clients' investment decision?**



Source: from interviews

This shows that there was not huge optimism (or certainty) about the impact of CC14 on the likely take up of further social investment by charitable trusts. More felt the increase would be small (less than 15%) than larger. The charitable trusts themselves were relatively downbeat about likely impact – only 18% of the trusts felt that more social investment would be forthcoming. This suggests there is much to do to help this agenda move forwards within the sector as well as further afield.

If banks and fund managers expect an increase, they may plan to become informed on social investment opportunities to meet this likely demand (this was discussed in 4.3.3.) As a broad indicator, we found that 50% of social and charitable banks, and 18% of commercial investment fund managers interviewed thought that there might be

a significant increase in charitable foundations engaging in MCI as a result of the changes to CC14.

### **Responsible investment strategy – a stepping stone to MCI?**

EIRIS<sup>34</sup> research (Collin, S. 2009) also suggests this reluctance on the part of many of the charitable foundations' mainstream investment strategy - the first step is to increase the take up of their engagement in socially responsible investment (SRI).

According to EIRIS's research, 60% of charities with over £1m and 25% of those with under £1m had a responsible investment strategy. It is likely that greater use of SRI strategies offers a stepping stone towards considering MCI. Without this step, it might seem too large for risk-averse trustees of foundations to reallocate even a small proportion of endowment to invest in blended propositions. One potential driver is the re-examination of whether Trustees' fiduciary duties may in fact *obligate* trustees to consider the ESG issues around any investment that they make. From there, the step to take part in social investment is considerably smaller.

### **Foundations and investment product development**

Within the sector pioneers such as CAF created collective investment vehicles designed to suit foundations' investment preferences. Esmée Fairbairn for example, used grant and loan combinations to support Investors in Society (developed in 1997), which later became Charity Bank. A group of active foundations are now considering the future development of a Mission Connected Collective Investment Fund, as an extension to the SRI CIF that EIRIS produced (which EIRIS recommended to be developed) in 2009. It will take time to build up the underlying securities and to tackle the range of different missions it would need to consider, and it is likely to require external expertise to take forward the financial issues, but it exemplifies the active role that some foundations are playing in supporting the creation of suitable products to fit their goals. Mission Related CIF product concept is discussed in more detail in 7.4.2.

Panahpur, a Trust which decided recently to seek to use its entire £6m allocation from grants to social investments, has co-funded (with NESTA and the BSB Finance Fund) the initial development phase of a selection of new social investment vehicles. Panahpur is most concerned with improving *access* to capital for social organisations. Along with other Foundations, it is interested in working in the longer term with retail banks and other commercial investment organisations with access to a wide customer base.

### **Appetite amongst foundations as early adopters**

Expectations are high for charitable foundations to underwrite a variety of investment gaps generated by risky investment propositions. Investment product developers should not assume that this sector will act as subsidisers of investors' commercial returns. In fact, one Foundation said that such a subsidy could be highly questionable under charity law's fiduciary obligations. However, those foundations which we interviewed were open to taking on 'differentiated risk' as part of a group of investors as a way of developing a concept of interest to them. Seventeen charitable foundations showed themselves willing early-adopters, investing in the first Social Impact Bond (SIB). If the SIB

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<sup>34</sup>Experts in responsible investment solutions: [www.eiris.org](http://www.eiris.org)

proves successful, it is likely that non charitable investors might be more attracted to consider later rounds of SIBs (see issues around vehicle design in Chapter 7). Where foundations see they can add value by taking risk ahead of other investors to test a model, they are prepared to engage. The arrival of the Big Society Bank (BSB) to the social investment marketplace will hopefully share this role with the pioneering foundations (see Chapter 9).

### **Measurement of social impact**

A recurring theme in discussions with foundations was continued frustration with the lack of a common approach towards ideal social impact measurements. This was tempered by recognition that this is one of the hardest issues to solve in the social investment agenda. The mission related impact generated by a social investment would need to be identifiable and measurable to some degree.

Foundations that have already engaged in social investment through MCI or PRI have found that the impact methodology has relevance for other areas of their grant programme work<sup>35</sup>. This has been an unexpected benefit of the engagement in social investment. It is also clear that the charitable sector with its long experience in impact creation and impact measurement can help to shape new thinking on social metrics. Charitable foundations can use their unique role as both creators and measurers of impact and as investors, to help create some clarity about meeting investors' expectations of the information that social metrics should provide (see Chapters 5, and 7, Products).

### **Opportunity for development**

There is clearly significant potential for charitable foundations to reallocate a portion of their endowment income to invest in social enterprises and businesses. To realise this potential, the tolerances and preferences of the foundations need to be better understood: these include the need for investment to enhance the mission, the need for effective measurement of the impact, and a realistic opportunity to recycle funds. This relatively new element of investment strategy (to most) will require greater knowledge about the investment options amongst trustees and investment managers of charitable foundations. It needs considerable support and advice to realise the greater potential for this across the top 500 foundations. The pioneers of social investment may help others to follow suit.

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<sup>35</sup>*This point is reinforced in* Imbert, D. and Knoepfel, I., "360-degrees for Mission". Stockholm: Mistra, 2011

#### 4.5.4 Key recommendations on vehicles for Foundations

1. Provide information and guidance to trustees on how PRI and MCI can impact on the mission
2. Build up expertise in-house on the range of investment opportunities emerging
3. Build on the initiative of certain active foundations to work together to consider the type of products that could be created to meet their requirements
4. Maximise the use of the expertise within foundations to take forward the social impact measurement agenda, to satisfy needs of a wide range of investors
5. Understand foundations' priorities : to develop investments that have potential to generate scale and must have clear exit strategies to be attractive to Foundations
6. Create investment vehicles with clear transparent structures and governance
7. Consider how to create tax incentives for social investment where individuals have already donated to or created their own foundations

#### 4.6 Mainstream Private Equity

##### 4.6.1 Description of Private Equity

Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Capital for private equity is raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet.

Private Equity investments also can provide high risk growth capital to purchase a business and then provide hands-on engagement to increase its value. It expects to turn round a company from purchase and out for resale in a maximum of 7 years (more normally 3-5 years), often less. The profit is made by reconfiguring the business whilst it is in the portfolio. The balance of debt and equity used in private equity deals significantly affects the returns that can be achieved – increased debt finance eats into the returns generated at sell-off.

So how far does this set of investors engage in social enterprise, and if not, why not?

##### 4.6.2 Main findings: action to date, barriers, preferred investment vehicles

###### Is Private Equity already engaged in social investment?

- Commercial private equity is hardly engaged in investing directly in social enterprises; support for private equity for social enterprise has been largely philanthropic
- There are no real drivers for engagement and limited knowledge of the sector within private equity
- Certain private equity investments could be considered to have social impact but the impact may be consequential and not the core purpose of the activity

**What are the barriers to activity? What would motivate them to invest?**

- Desired risk adjusted rates of returns are in the region of 18-28% although this is hard to achieve even in the fully commercial sector, and have declined recently; rates of return offered by social enterprise investments do not compensate for the perceived risk they offer
- Measurement and benchmarking of social impact needs greater substantiation, to attract HNWI clients of venture capital firms to engage in social enterprise start-ups
- The room to turn these social enterprises round quickly is limited as the markets are often slow to develop, especially if the revenue stream is reliant on public sector contracts
- Restrictive legal forms are not appealing to private equity investors as they inhibit diversification of returns across a portfolio
- Managing social businesses as part of a mainstream portfolio is time consuming and problematic as they require different analysis, considerations and impact measurement

**What type of investment vehicles would they favour and on what conditions?**

- Private equity and venture capital could be attracted to social impact investment in emerging countries where social impact is perceived to generate higher financial and social returns, to date
- Joint ventures between social enterprises and commercial organisations could be of interest if they offer equity, have clear market position, potential for market rate plus financial returns and generate evidenced social impact
- Equity investments are more appealing than debt; social enterprises are increasingly offering equity
- Sector to track record, seeks growth capital, offer obvious exit route, then private equity could become more engaged
- More robust social impact measurement mechanisms would help engage this sector in social venture start-ups; urgent need to progress on this front

There has been private equity donor support to organisations such as Impetus Trust, CAN (from Permira) and into the Private Equity Foundation but for the large part, these organisations do not make investments. They provide grants and support to social enterprises and charities. The private equity sector provides considerable pro-bono mentoring and support to social enterprises through these organisations. Our sample size of private equity firms is too small to draw up charts to reflect their combined positions but interviews suggested that the risk mitigated rate of return was such an overwhelming barrier to investment in social enterprises currently that were not offering finance first return rates that it dwarfed other considerations, which were a better fit (e.g. investment size, fund structure, and level of engagement).



### 4.6.3 Specific Issues for Private Equity

#### **Key criteria for private equity investment**

The investment agenda for a private equity house will be influenced by the following issues:

- the sector in which an investment proposition is located: is the sector disaggregated, is there room to consolidate the sector, or is it already developed and integrated with little room to add value?
- the position of the investee within the sector, for example, market share, its 'unique selling point' and its reputation
- the management of the investee organisation: can this be improved upon?
- the underlying cash flows of the investee
- an exit strategy - is there an obvious market to sell this enterprise to either up or down the value chain, ideally within 4 - 6 years of purchasing?

Social investments would need to rank well against these criteria to stand a chance of gaining investment from a private equity house.

#### **Expected and actual rates of return**

Private Equity firms such as 3i, have invested in Bridges Ventures first two 'finance first' funds. These funds have generated returns in line with the commercial rates sought by investors,

When interviewed, private equity reflected the least hope for investment in social organisations. The biggest barrier was the perception of expected returns. The average commercial private equity firm would not consider expected returns of less than 18% net, and would seek to exit the investment after 4 - 6 years. This makes expected returns from social investments of around 5% (best case) infeasible as an investment proposition.

However, Table 4.6.3 shows the actual rates of return generated from different asset classes since 1981 to 2005. The lack of stability since 2005 serves to reinforce the discrepancies between expected and actual rates of return achieved over a variety of asset classes, including Venture Capital, since 2000. With reduced equity to debt ratios since the financial crisis, there is less room for net profit in the high teens or 20% range.

**Table 4.6.3: Actual average upper and lower rates of return across different asset classes, 1981-2005**

		Cash	Quasi Equity	Public Equity	Buyout	Venture Capital	Real Estate	Commodities
1981-1990	Average Lower Bound	6%	7%	10%	16%	8%	5%	N/A
	Average Upper Bound	10%	13%	16%	22%	18%	15%	N/A
1991-2000	Average Lower Bound	3%	4%	5%	8%	25%	8%	3%
	Average Upper Bound	6%	8%	10%	14%	45%	15%	12%
2001-2005	Average Lower Bound	1%	5%	4%	-10%	-12%	12%	5%
	Average Upper Bound	4%	10%	10%	2%	2%	20%	15%

Source: *Bridges Parthenon GIIN Report, Investing for Impact, case study across asset classes, 2010*

Note:

Range considered was 2001-2008 for Quasi Equity, Buyout and VC<sup>36</sup>;

Benchmark Returns/Indices used:

Cash: 3 month discount rate on US Treasury bills

Quasi Equity, Buyout, VC: Cum. Vintage Year Return, US Private Equity Performance Index, Thomson Financial

Public Equity: MSCI World Index

Real Estate: Dow Jones Wilshire US REIT Index

Commodities: Dow Jones AIG Commodity Index

Whilst these averages vary across regions, this table shows the considerable gap between desired levels of expected return on buyouts and venture capital and the actual returns. It also reflects the high levels of standard deviation within the sector. A small number of successful firms make high returns in line with their expectations, but most do not.

This offers some room for social enterprises to show themselves competitive in the long run as the average upper bound from VC funds and buyout funds from 2001–2005 are lower (2%) than many social enterprises can deliver currently. The lower bound (– 10%) is also not incompatible with social enterprise returns in their early years. However, this could be because of the down-cycle and may not fully reflect a real market opportunity.

Community Interest Companies (CICs), with their capped profit distribution and dividend incomes, are perceived as unattractive by commercial private equity houses,

<sup>36</sup>Taken from *Bridges Parthenon GIIN Report, Investing for Impact, case study across asset classes, 2010*.

not just for because of their own risk profile, but also because they are limited in their ability to offset poor returns from other holdings.

### **Role of expectations in investment decision making**

This analysis highlights the importance of expectations in determining an investment decision. If it is clear in advance that returns on social investments will be near 5%, the proposition would often be rejected, because other propositions are being marketed which potentially deliver much higher returns. The fact that few of them do has not seemingly altered the expectations. But a readjustment of expectations could offer an opportunity for social investment to find an improved position within the commercial private equity houses in the longer – term. Social investment returns might be uncorrelated and seem to have lower return variability. This needs to be verified as the data base builds up and then presented as part of the case made to investors.

### **Venture capital – the role of individual investors**

Venture capitalists face standard difficulties of spotting the potential return of any start-up business whilst considering the risk of its having no track record. A social enterprise investment start-up presents the same difficulties but adds a third dimension of how to value the social impact it plans to create. The risk adjusted expected rate of return sought by venture capital investors financing social start-ups is likely to be very much higher than the enterprise can support. There may be particular difficulties in exiting the investment too.

So far, venture philanthropy<sup>37</sup> has been a financing model used by social enterprise. In this approach, the intense focus is applied to high social impact businesses, and scale is sought and measured. There are, however, mainstream venture capital firms with HNWI clients potentially interested in social investment rather than philanthropy. Clients want to make informed decisions, strongly influenced by the basis of the social impact that the investees could help generate. As long as social measurement systems are perceived as neither consistent, nor benchmarked to provide for reliable comparisons, these investors' appetites are not easily met.

#### **4.6.4 Key recommendations on social investment vehicles for private equity**

1. Increase use of equity by the sector in the long term to diversify funding options for enterprises; social sector needs to help to develop the market place for social enterprises to be 'sold in to' – working with commercial counterparts helps to widen the marketability of social enterprises
2. Make use of the pro-bono support to help build capacity in the sector
3. Continue to work on the measurement of social impact with attention to the requirements of different investors

In general, the social enterprise sector needs to lay down preparatory steps to engage with private equity before approaching it for capital.

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<sup>37</sup> *Venture Philanthropy takes concepts and techniques from venture capital finance and high technology business management and applies them to achieving philanthropic goals*

## 4.7 Social Private Equity

### 4.7.1 Description of Social private equity

Social private equity differs from its mainstream counterpart in that it aims to invest in impact generating private companies or organisations. These returns may be anywhere along the spectrum of finance first, blended or impact first. It uses the tools and structure of mainstream private equity to achieve these social or environmental aims. The feature of this type of equity is its emphasis on impact. As Bridges Ventures states:

*"funds that we raise aim to achieve dedicated social and/or environmental goals as well as aiming to achieve financial returns for investors".*

Social Private Equity can be defined as capital invested in non-public companies engaging in profitable, positive social impact driven activities. The total stock value of social private equity for investment rather than for donation in the UK is in the region of £200m, including about £30m - £50m which offers blended / impact first returns. Table 4.7.1 draws up the known social private equity within the UK sector currently available or under development:

**Table 4.7.1: UK Social Private Equity Funds known of to date**

Fund name <sup>38</sup>	Finance or Impact First	Size of fund	Types of finance offered	Capital intended for:
Bridges Ventures Funds 1, 2	Finance First	£115m	Equity	Growth
Bridges Social Entrepreneurs Fund	Impact First	£11.75m	Quasi-equity, equity	Growth
Big Issue Social Enterprise Investment Fund	Impact first	£7m to date (2011)	Quasi-equity, equity and debt	Growth
Finance South East	Blended	£2.5m target	Debt and equity	Start-up, scale up
Resonance Social Care Property Fund	Blended	£20m target (funds under development)	Range of products from underwriting to bridging loans and equity	Asset loans, working and growth

CAF Venturesome is listed in 4.5 under charitable foundations. This fund operates as an open-ended, evergreen fund

<sup>38</sup> See Matrices in Annex for further details on these funds

#### **4.7.2 Main findings: action to date, barriers, preferred investment vehicles**

##### **Is social venture capital already engaged in this sector?**

- These funds are specifically established to invest capital into social enterprises and organisations; they seek and generate blended returns for investors
- The funds have similar portfolios and there is a high degree of concentration within the sector
- These funds innovatively combine social loans (quasi-equity style products), fixed and variable loans and equity shares into investment packages
- Commercial investors, especially banks, have made investments into these funds
- Triodos bank also created a social enterprise venture fund but closed it after making only one investment

##### **What are the barriers to activity? What would help them invest?**

- Low numbers of investable propositions offering equity share, although there is some evidence of this picking up of late, and the public sector spin-outs may accelerate this
- Difficult to balance demand for growth capital from enterprises with supply of finance, given the need to provide return to investors; capital is raised slowly which helps to keep supply and demand for capital in line with each other
- Sector is in development, so hard to detect the investable propositions; market place largely untested and only one firm with the beginnings of a long track record — Bridges Ventures (opened in 2002)
- Difficult to balance institutional investors' preference for quick returns with sector's needs for long term patient capital; donations to funds have helped to kick start this sector
- Each investment demands a high level of engagement, so portfolios reflect this
- High fund set up and management costs make the necessary levels of return to break even difficult to achieve in the nascent market (c3-5% net); donor or underwriting support (e.g. from BSB) to the social private equity funds needed

##### **What type of investment would they favour and on what conditions?**

- Equity and quasi-equity or loan investments which 'self-liquidate' at exit
- Loans or guarantees from BSB as co-investor in risky but desirable investments
- Co-investing in public sector spin-outs and public service providers: potentially a big opportunity for the sector
- Initiatives that help build up enterprise base; exchange best practice efficiently
- New funds are in development e.g. Resonance is developing two social venture funds (see details in Annex).

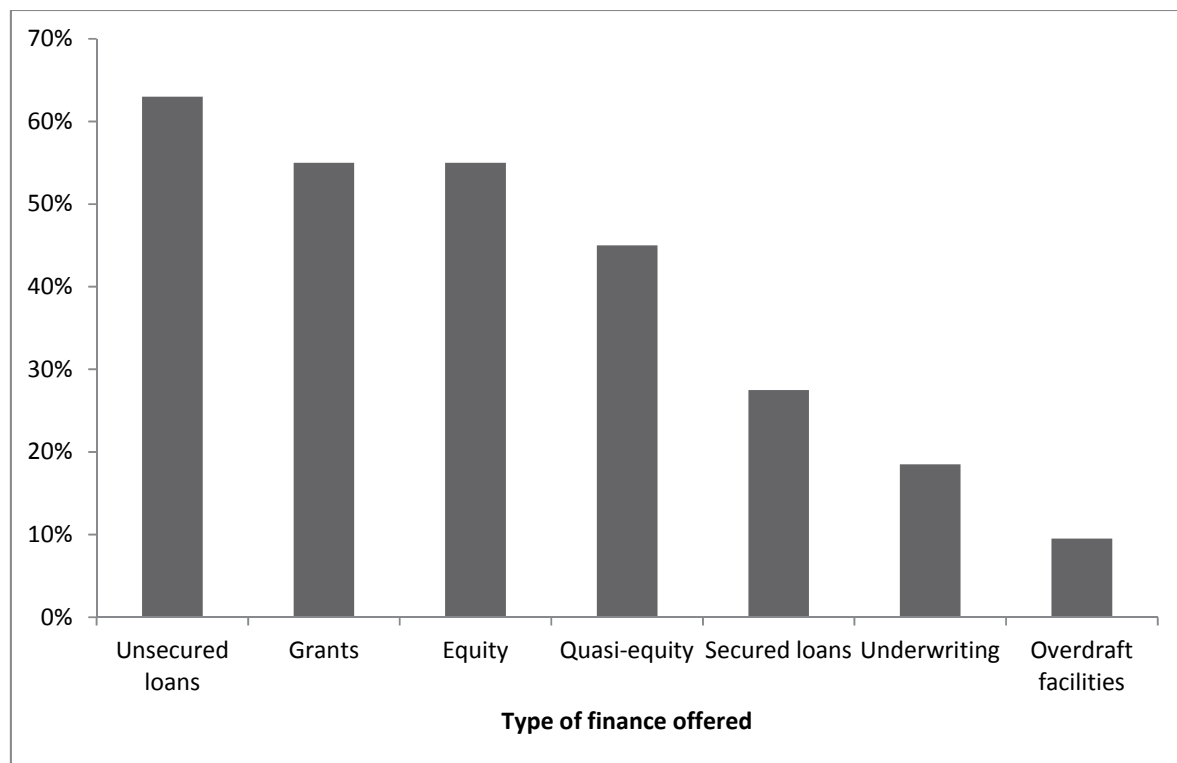
### 4.7.3 Specific Issues for Social Private Equity

Social Private Equity is established to generate blended returns for investors. They need to attract investors into funds to provide growth capital to social enterprises. This requires a steady stream of investment ready enterprises for investment. Whilst funds have been successfully raised, there has to date been a shortage of investable propositions, although there is some evidence of improvement of late. Management costs of these funds are high; enterprises require tailored support. Increasingly, investors into the funds are willing to offer some degree of mentoring support to investees. Bridges Ventures has a strategic partnership with the Monitor Group to offer pro-bono consultancy and advice to new investees. Big Issue Invest increasingly looks to use mentoring resources from investors to support investees. These organisations seek to be engaged in their investees and hold a seat on the Board.

The shortage of investable propositions has been a barrier to faster growth in this area, not the shortage of the finance itself. This is an important point to tackle when seeking to lever further capital. Triodos Social Enterprise Fund raised £3m to invest in growing social enterprises. It closed the fund after one year in 2010, with only one deal made, after receiving over 280 applications. The applications did not meet their requirements for near market rate returns offering equity investments. This suggests the need to provide investment readiness training programmes, such as the previous Social Enterprise Access To Investment (SEATI) programme run by NESTA in 2009. There is also merit in determining whether availability of capital does, over time, itself generate the types of investment proposals that investors seek (by establishing successful standards). Social business angel networks have been particularly active in generating a growing pool of investable propositions and seek investment for these enterprises by engaging with all social private equity firms.

The different types of investment vehicles offered by social intermediaries are given in Chart 4.7.3.

**Chart 4.7.3: Types of finance available but not necessarily provided to social enterprises**



Source: Shanmugalingam et al., 2011

Chart 4.7.3 demonstrates the availability of different types of finance offered by the social financial intermediaries. Social private equity is the largest provider (after the government) of equity and quasi-equity. There is currently approximately £19m of growth finance (offered in equity, quasi-equity, unsecured loans) from the two main social private equity firms (Bridges, 11.75m and Big Issue Invest £7) and additional unsecured loan opportunities from Venturesome for bridging and transition finance. Nevertheless, the demand for equity, quasi-equity and unsecured loans is less than the demand for secured loans and grants, which is not social private equity's core product. This may well change as the sector develops and moves further away from its grant based-roots.

Working capital and loan finance is also provided by social private equity firm Big Issue Invest. Its Loan Fund has supported 27 organisations with nearly £7m of capital. All investees are social enterprises providing measurable impacts across a wide range of social and environmental themes. These terms are set with a 3% interest rate floor and are usually provided at 6-8% and offer loans between £50,000 - £500,000.

Quasi-equity is a proxy for share capital in which investors are offered a percentage share in the increase in revenues to the business generated as a result of the investment. It is an attractive tool for the sector, especially where there is no share capital (as in the case of charities). Social venture capitalists offer this form of investment. It is relatively new and as yet there is not sufficient evidence to assess its

effectiveness as an investment tool for both investor and investee. Big Issue Invest seeks net quasi-equity returns of around 5% and a blended fund return on its Social Enterprise Investment Fund of 3 – 5 %. This is in line with the targets for Bridges Social Entrepreneurs fund.

### **Support from Government funds and now The Big Society Bank**

To date, there has been an opportunity for government funds to co-invest with social private equity in social enterprises. This is due to run out soon; only the Government's Social Enterprise Investment Fund (SEIF) which focuses on financing health and social care service providers, is expected to be able to offer finance in the immediate future. (See section 8). BSB's capital support for this sector may inject the much needed finance as the public sector spin-outs and sector growth increases demand. This will depend on the rates of return required to finance capital provided by the four commercial banks-the "Merlin Banks".

#### **4.7.4 Key recommendations on vehicles for Social Private Equity**

1. Focus on developing the pipeline from investible enterprises seeking growth capital through to investors seeking blended returns
2. Social entrepreneurs need to create and offer equity investments
3. Attract commercial entrepreneurs to become 'social entrepreneurs' (e.g. through tax, through contract preference, 'positive branding' as social entrepreneur), thus extending the range and types of social enterprises offering investment opportunities
4. Continue to build links with business angel networks to link investors with investees
5. Provide considerable long term mentoring and support for investees to ensure good investable businesses are able to deliver on their expectations
6. Help social private equity provide the needed investment for social enterprise public sector spin-outs and public service providers through co-funding arrangements with other interested investors
7. Gain financial and resource support from Big Society Bank to develop products and infrastructure
8. Create pooled finances of patient capital in recognition of slow speed of building up the social investment market
9. Take best practice internationally to see what business models work best and how applicable they can be in the UK (e.g. India's use of price discrimination in services, wider use of franchising in social enterprise)
10. Develop further and co-ordinate expertise in social impact measurement across the social sector, drawing on international best practice and networks; work with investors to establish investor requirements into social impact measurement
11. Identify key investors into social private equity and target investment propositions with these in mind



12. Consider alternative structures within social private equity e.g. creation of an investment trust fund to extend the range of investors that would be able to invest in these organisations

## 4.8 Independent Financial Advisors and consultants

Independent Financial Advisers (IFAs) are professionals who offer independent advice on financial matters to their clients and recommend suitable financial products from the whole of the market. They focus on the products that go to the retail market. Financial consultants, on the other hand, serve institutional investment houses, advising from strategy, structure and implementation through to on-going portfolio management. Increasingly, financial consultants engage in multi-manager investment strategies to diversify risk by spreading investments over a multiple of specialised funds.

### 4.8.1 Description of their role as gatekeepers

Although IFAs and financial consultants are not investors, they play a critical role in taking products to investors for their consideration. IFAs are the gatekeepers to many retail clients and financial consultants advise many of the large pension fund managers. It is therefore important to include them in the analysis of different types of financial institutions.

### 4.8.2 Main findings: action to date, barriers, preferred investment vehicles

#### Are they already engaged in this sector?

- Our research has uncovered only a limited number of specialist financial advisors (IFAs) engaged in social investing. Where these exist, they are highly active and innovative
- There are more IFAs focused on environmental impact investment opportunities than on social investment, partly because there are now a greater range of products available for environmental investment
- Financial consultants we contacted were not active in social investment; it was hard to engage with this sector in our research, although they were heavily engaged in SRI investment advice

#### What are the barriers to activity? What would help them invest?

- There are no incentives for IFAs or consultants to offer these products to clients – they generally offer no commission and are harder to place in a portfolio
- Limited knowledge about social investment restricts engagement – a better link with IFAs and the Association of IFAs (AIFA) to educate the advisors on the possibilities would be a good start
- The products are largely available to sophisticated investors to date, and are under the FSA regulations are not marketed to retail investors to purchase (this rules out an entire market segment)

- Creation of a bespoke community and social finance regime to provide clarity and exemptions to FSA regulations for this sector

#### **What type of investment vehicles would they favour and on what conditions?**

- Products with clear social impact measured and verified, to justify the lost financial return
- Products which provide risk adjusted levels of return mitigated either by underwriting, structured finance or fixed rates of return
- Products that can be sold in large number with high market value
- Products that are easily trade-able, explainable, with a story to tell
- Investment propositions that are transparent and provide balance to a portfolio

### **4.8.3 Specific Issues concerning IFAs and consultants**

The IFAs and the financial consultants act as the gatekeepers to investment decisions. It is very difficult to bring a product to the attention of a fund manager without their involvement. Marketing products to investors who are not 'sophisticated' falls under FSA regulations. However, proposals for the creation of a bespoke community and social finance regime would help to provide proportionate regulations and costs to this sector as it seeks to raise investment (Fletcher, L., 2011). To date, nearly all the social investments have been targeted at sophisticated investors, and are therefore not marketed widely.

The sale of retail investment products to purchasers has been the focus of the Retail Distribution Review, (RDR,) which is due to come into force in December 2012. Instead of the commission based system, which some IFAs operate currently, all IFAs will be paid on a fixed fee basis, with no incentives applied, to sell certain products. This levelling of the playing field offers an opportunity for social investment, the products of which generally do not offer commissions.

In the course of this research we uncovered some innovative ways to create social investment products. One IFA<sup>39</sup> engaged in a wide spectrum of ethical investments has helped to set up a bespoke social investment 'package', comprising a range of different investment opportunities. The minimum investment was £50,000 and the investment products comprise a broad range of socially directed or ethically acceptable 'social bonds'. This includes IFFIm bond, Co-op Bank, John Lewis and HCT Group. These could be selected by the client to suit their income/ethical needs. This investment package could form the basis of other social investment products 'wrapped' to suit different target investors.

With a few notable exceptions, the IFA sector does not appear to be engaged or informed on social investment products. There is a real need to engage with the Association of IFAs, (AIFA), to develop an information programme which addresses these issues. The same applies in the case of investment consultants who are similarly unengaged, for the large part, in social investing. Until the wealth and fund managers

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<sup>39</sup> *Ethical Investors, Cheltenham, UK*

call for it, there is no incentive for IFAs to provide this. And they will not call for it until their clients call for it.

In carrying out this research it was hard to engage with these organisations as a whole. The establishment of the BSB and its vision as a champion for the sector makes it ideally placed to create rapport with the Association for IFAs and with the Institute of Financial Consultants. It should present new developments in the sector regularly to their members and determine how best to take a product to market through them. It could aim to work closely with them to understand market needs and routes to market. This will become increasingly significant as the social sector develops. In time, the sector will be better placed to create and market retail products in due course, and to work with the range of financial services bodies that work to take a product to market.

#### **4.8.4 Key recommendations for engaging Independent Financial Advisors (IFAs) and consultants in social investment**

- Engage with these consultants and advisors to ensure products reach intended market
- Discuss possibility of retail products in future with IFAs to understand barriers
- Build up the knowledge bank of social investment opportunities amongst IFA
- Use the change to Retail Distribution Review (RDR) regulations as an opportunity to open up this conversation
- Work with IFAs on proposed altered regulatory framework around investing in civil society<sup>40</sup>
- the BSB could represent the sector to the AIFA and run seminars about the sector
- Product developers should engage and use IFAs' knowledge of the market
- Examine how tax incentives to encourage individual investors would help IFAs to promote the products

#### **4.9 Summary of investors' perspectives on social investment**

In general, and unsurprisingly, the structure of an investment vehicle and the type of asset offered for investment was less important than the robustness of an investment proposition. However, structure can make it easier for an institution to take a social investment, if the proposition is attractive. And this will depend on the precise preferences of the investor.

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<sup>40</sup>See NESTA paper, *Investing in Civil Society*, by Luke Fletcher, Bates Wells, Braithwaite, 23 June 2011

To recap on some key investment vehicle preferences:

- An OEIC<sup>41</sup> structure is more suitable for SRI investment managers than for a pension fund (according to our survey)
- Investment banks were flexible being able to invest, in theory, in both OEICs and into limited partnerships. They generally preferred holding debt to equity
- Charitable foundations invested both into social venture funds and made direct investments, according to the circumstances. This group of investors were flexible on holding bonds, equity or quasi-equity investments
- Social venture funds preferred to invest quasi-equity or equity into their investees, but would accommodate debt holdings too
- Social and charitable banks offered equity holdings into their organisations and provided debt based on-lending to social enterprises
- Retail banks also provided debt based lending to charities and social enterprises.

We find that no one size fits all; the matching of investment propositions to targeted investors is an intricate process requiring considerable preparation and research, reiteration and collaboration between investor intermediary and investee. The reputation of a fund originator was a critical feature of an investment decision – which highlights the human aspect of all investment decisions – the need for confidence in any investment decision. In Chapter 7, we match these preferences with available products.

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<sup>41</sup> Such as an Open Ended Investment Company, an OEIC, or a closed structure, such as an investment trust

## 5 Social Investment as an Asset Class?

An asset class is a group of securities that exhibit similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations. The three main asset classes are equities (stocks), fixed-income (bonds) and cash equivalents, and some professionals would add real estate and commodities, and arguably hedge funds, to these.

Could/should social investment be considered an emerging asset class or is it more of a 'movement'? This was the question posed at SOCAP conference in June 2011.<sup>42</sup> The question is important because it could affect the amount of mainstream capital that the sector could ever attract.

The argument appears to be framed in the following way: if social investment were to be considered an emerging asset class, it could more readily find a place in an investor's portfolio. However, attaching 'asset class' status to social enterprise might in itself segregate it from the mainstream, thus weakening an opportunity to embody social impact as the third dimension (after risk and return) into mainstream investment decisions. Interestingly, in its business plan the BSB pins its success to the establishment of social investment as a '*recognised asset class over the next two decades*' (BSB, Outline Business Plan, May 2011).

J. P. Morgan's paper on Impact Investment an emerging asset class (O'Donohoe, N. et al., 2010) identified key criteria necessary for an asset class. We assess how well these appear to be matched by progress on the ground and then provide feedback from the interviewed investors of their perceptions on the debate.

### 5.1 Criteria for asset class

J. P. Morgan's paper, describes determinants of an asset class to include:

- the aim of adopting standardised metrics, benchmarks and ratings
- a unique set of investment / risk management skills
- structures to accommodate this skill set serviced by industry organisations

One could add to this list:

- perception of a cohesive grouping of investment vehicles
- availability and access to investment opportunities

#### **Standardised metrics, benchmarks and ratings for measuring social impact**

The measurement of social impact is one of the biggest challenges facing the sector. There are currently a range of methodologies for wide use within and across different sectors of impact assessment, (some of which are discussed in Chapter 7 in relation to the products that would meet investors' needs).

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<sup>42</sup> SOCAP - Europe (The Social Capital Markets Conference)

However, the overwhelming issue that needs resolving before we can establish standard metrics, benchmarks and ratings for measuring social impact is finding out what investors wish to capture. Do investors, in general, want an 'aerial view' of what has been achieved by an investment across a range of key variables? Or, do investors seek a detailed, in depth, time series analysis of the long term impact of an investment? (For example, to measure the effect of a programme to relieve unemployment on the lives of beneficiaries) Such an analysis may well be beyond the scope of many social enterprises to provide without subsidy or resource support. It may also be beyond the time limits of investors to examine this in appropriate detail, thus making the requirement somewhat redundant. We identified in Chapter 4 that the bespoke considerations of social investment are in itself a barrier to many investors because of the demands on their time. We need to ensure we provide social impact measurement that aids their investment decision, not hinders it.

ClearlySo sees the need for a crucial step in social investment's route towards becoming an asset class. This is to determine the required level of social impact measurement that investors seek to use in making investment decisions. We recommend further in depth forums with investors to take this forward in the near future. The approach to impact measurement that BSB adopts in assessing its own investments to social financial intermediaries will be very important in setting the tone for further development.

### **Investment skills and structures**

There is growing evidence that the required unique set of investment and risk management skills are developing within the social sector. We can begin to see the specialisms of impact investment appearing in job advertisements and the transfer of talent and skills from the commercial world to the social sector is another encouraging sign for its long term development.

A variety of structures to accommodate the market's needs are in development. The BSB is a significant addition to the UK's infrastructure: it will support the development of further platforms and products. Other structures under development specifically for the sector include the creation of a Social Stock Exchange, which, whilst clearly ahead of its time, plans to provide the necessary infrastructure between the social sector and the mainstream institutional investor. Additionally, CAF Venturesome and other social investors are developing an investment re-financing platform called Shared Impact. Ethex is a planned platform to help the shareholders of social enterprises to trade and manage their holdings more easily.

### **Access to a cohesive group of investment vehicles**

The creation of a cohesive group of investment vehicles is continuing work in progress. NESTA's Big Finance Fund received 89 propositions, of which 20 were selected for further consideration and four have received development funding. This volume of ideas reflects the growing levels of innovation in product design. Many of these vehicles are aimed at creating improved access to social investment opportunities. Creating mass market retail products is still some time away. This is discussed further in Chapter 7.

Thus, according to J.P. Morgan's criteria, it appears that the UK social investment market is beginning to moving towards the status of an asset class. ClearlySo asked how interviewed investors felt about this; would it make a difference to the take up of social investment?

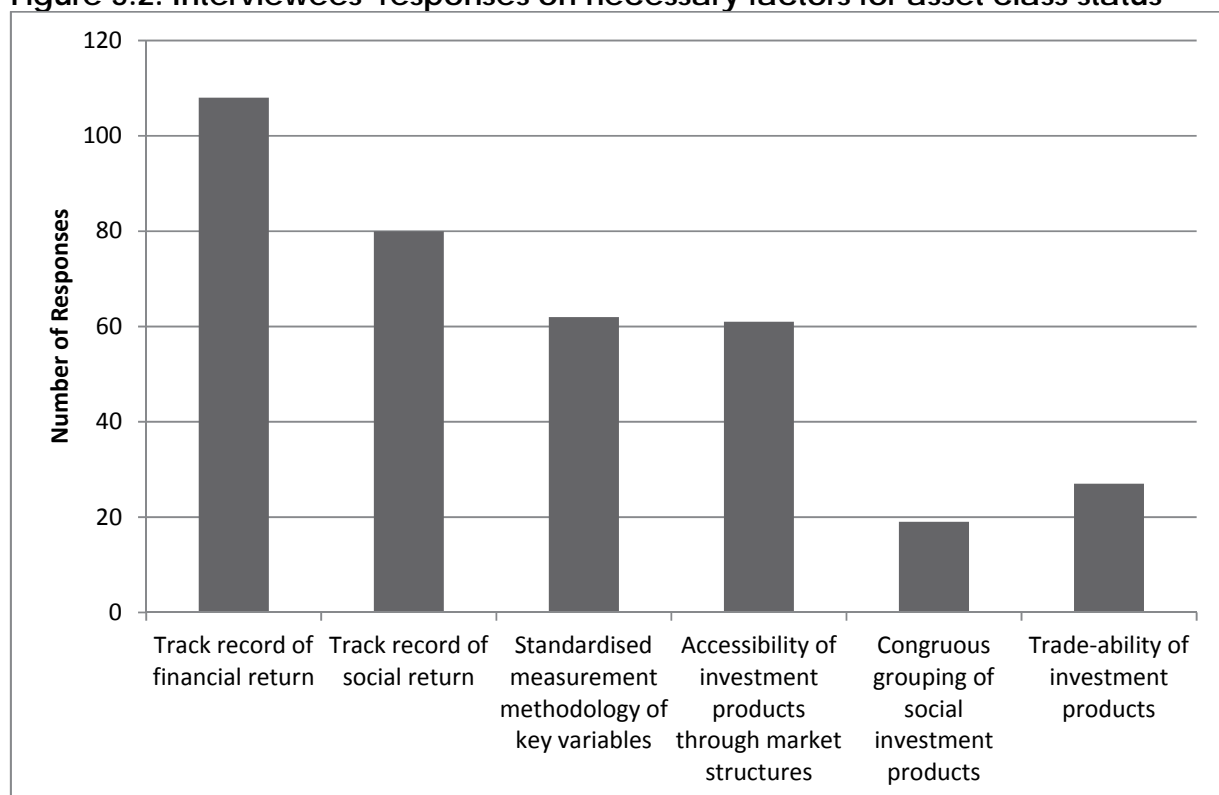
## 5.2 Interviewees' perceptions of required developments for asset class

Interviewees were asked:

- whether social investing could become an asset class
- which developments would be required for it to become so
- whether the establishment of an asset class would help increase the take up of social impact investing.

The results from our survey showed that 33% of interviewees felt that social investment was emerging as an asset class. Just over another third were not sure. 6% felt that it was already an asset class. 12% said that it was not relevant. Figure 5.2 shows interviewees' views on the necessary factors for social investment to be considered an asset class.

**Figure 5.2: Interviewees' responses on necessary factors for asset class status**



Source: research for this report through interviews

### The need for track records in blended returns

The results show that the most commonly stated requirements for social investment to emerge as an asset class were the development of a financial return and of a social

impact track record. Ultimately, investors need to see the results of a blended proposition and be confident in investing for both financial and social returns. Investors interviewed felt that for the growth of the sector's credibility, standardised metrics, structures, skills, and product availability should also be developed further.

### **Would the asset class label accelerate investment?**

More generally, investors thought that the categorisation of social investment as an asset class could help with the problem of finding a suitable allocation for it, in much the same way that hedge funds developed as an asset class. Some observers see flaws in this logic, stating instead that:

- hedge funds became 'housed' via an asset class status only because the deal flow and levels of activity made this sector profitable enough for the investment banks to focus dedicated resources on them. Social impact investing will be unlikely to generate significant levels of similar profit for many years, so the motivation to create an allocation to host it within financial institutions will remain absent
- impact investing is, and should be, recognised as the third dimension to all conventional investment, after risk and return. It should become an integrated component of the mainstream investment decision
- defining social investment under a separate asset class may marginalise it: this argument is sometimes used in relation to social stock exchanges and other mechanisms that seek to treat social investment separately because of its specific features.

### **The balanced portfolio argument**

The beta value of a stock or share is an historical measurement of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. A low beta implies that it is less volatile than the market. A higher beta is usually expected to carry a corresponding higher return rate to compensate for the potential risk of market volatility.

Protagonists for the social sector often argue that institutional investors should hold social investment in their portfolio as a balance against other holdings which might all perform in the same direction as the market. This implies that social investment, if it were to be considered a separate asset class, has a lower beta. However, as one banker interviewed put it *"this would need to be shown through track record and analysis rather than mere conjecture."*



### 5.3 Conclusions on asset class in the context of impact investing

Our research suggests that, although the market is developing many features of an emerging asset class, it still needs time to build up financial and social track records. The BSB outline business plan suggests it will require two decades to achieve this.

Social investment is part of a larger group of impact investing,<sup>43</sup> some aspects of which are developing the features discussed above. But the specific features of social investment make it harder to grow at the pace of micro-finance and clean technology investment, particularly in the developed world today. Perhaps together they could all become an asset class, or part of the asset class currently described commonly as "alternative investments."

Whilst for some investors, defining social investment as an asset class of its own would help in allocating investments, there were other investors interviewed who felt that it might be neither important nor desirable for social investment to be designated as an asset class. If the aim of the label is to extend the investor base, it will first be essential to provide a range of underlying social investment securities of determinable value. They can then be branded in a way that is most manageable for the target investors.

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<sup>43</sup> Jessica Freirerich and Katherine Fulton, (2009) *Investing for Social and Environmental Impact*, Monitor Institute

## **6 Finance First/ Impact First?**

### **6.1 No one size fits all - many different profiles**

The range of institutional investors surveyed for this report may be categorised loosely by one or more of the following profiles:

- 'finance first' impact investors
- 'impact first' investors
- those with a combination of finance and impact first (mixed motivations)
- non-impact investors/ traditional mainstream investors

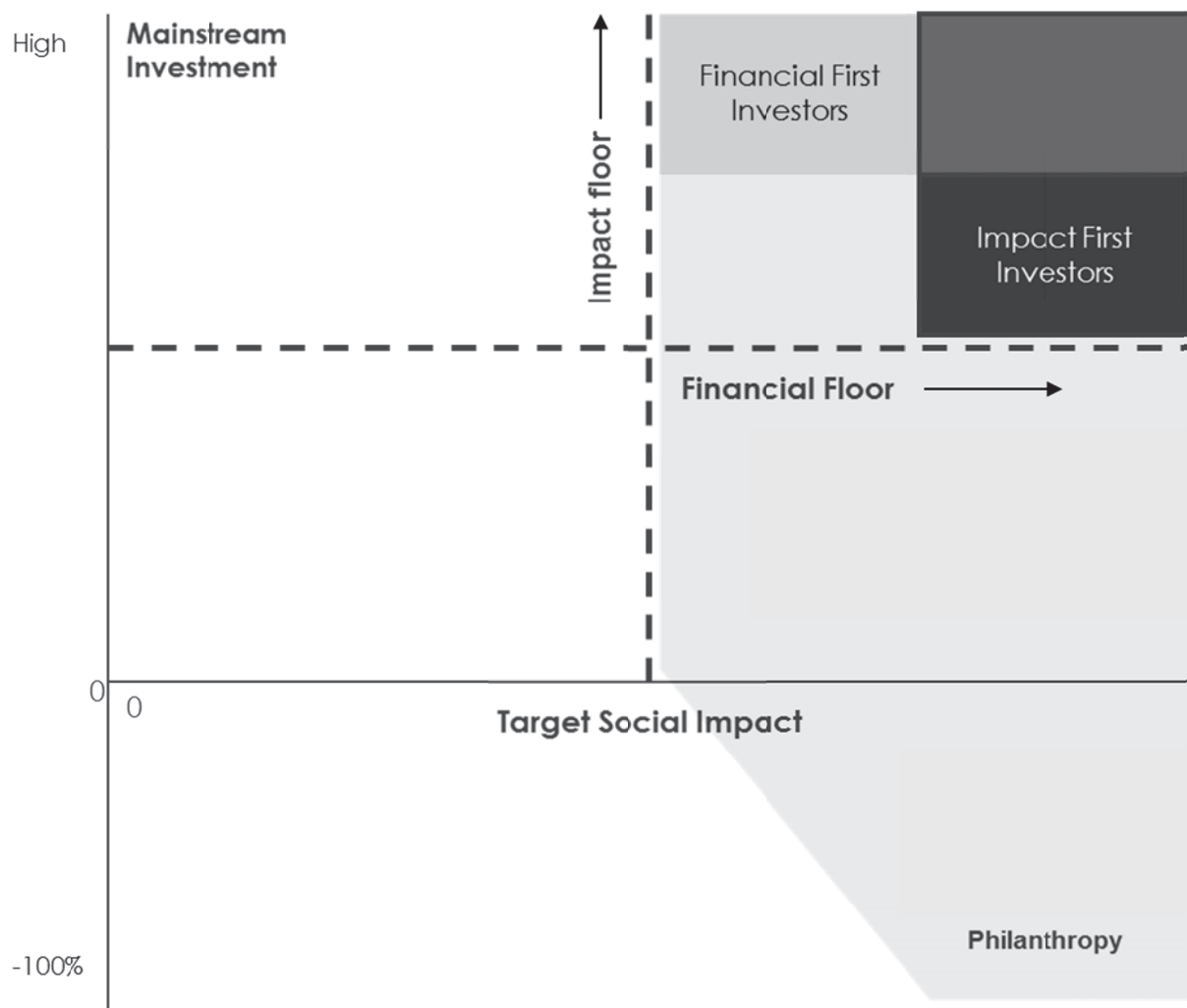
(See Chapter 2 for definitions on these terms)

These two concepts imply a degree of precise delineation which is not the case in practice. *Blended* social and financial returns, with varying degrees of trade-off between each other, are more common. In reality, a variety of financial floors exist amongst and within investor types with regard to different investment opportunities. Social entrepreneurs, who are seeking finance, need to know which investors they are targeting and their preferences when presenting a case to attract investment.

### **6.2 Matching challenge: model to 'nudge' investors**

These concepts highlight the potential room for "nudge" and negotiation between investor and investee and may be useful in considering how to accelerate social investment. The following two diagrams give a possible model to describe the nudge that social investment seeks.

Figure 6.2a: Diagram describing the landscape of different types of investors



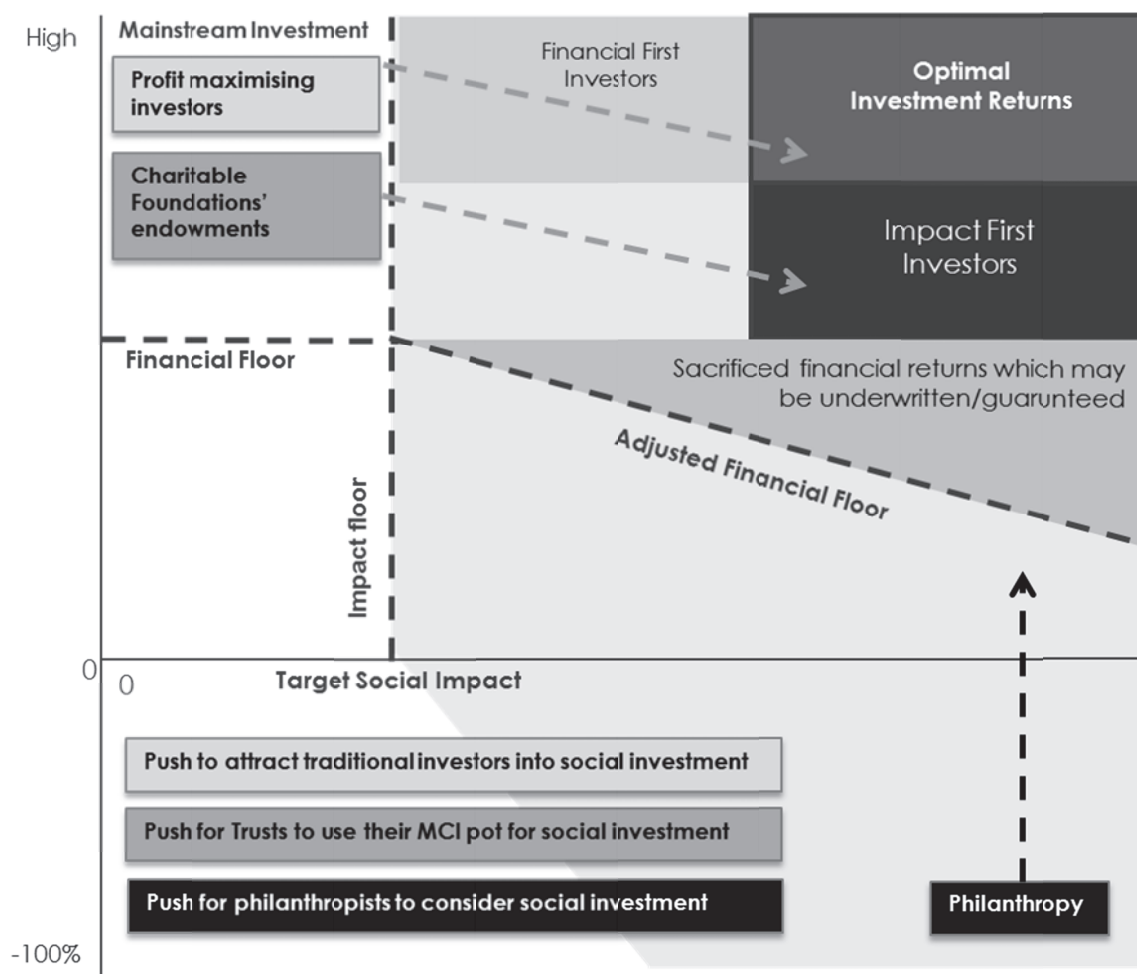
Source: Freireich, J. and Fulton, K., 2009, Monitor Institute

In these two diagrams, we plot the financial returns expected on the vertical axis and the social returns on the horizontal axis. The dotted lines reflect certain 'floors' below which different investors may not be prepared to compromise. The area of blended returns is of most interest where financial and social thresholds are both met.

#### What would move investors into the blended area?

The second graph, Figure 6.2b, depicts the room for nudges that could be employed to move investors (including charitable foundations investing their endowment income) from only receiving financial returns with no social impact to investing for blended returns. It also describes the room to nudge philanthropists to consider 'recycling' their finance through social investment.

Figure 6.2b: A model to describe potential for 'nudge' into impact investment



Adapted from Monitor Institute, Investing for Social and Environmental impact, 2009

There are a number of different nudges that could be used to move investors into different positions, as shown in the following diagram. The mechanisms could take the following forms:

**Mainstream investors** could be:

- nudged from traditional mainstream investment with high financial returns towards comparable financial returns but with increasing social returns. This pushes them into the area where, for the same financial returns, they choose investments which also generate social benefit. This is not a difficult proposition to sell, but is hard to find such opportunities in the UK social sector to date.
- nudged from traditional mainstream investment downwards towards higher impact but reduced returns. If returns are substantially reduced, the financial floor might need to slip downwards, sacrificing some financial return for social return. The shaded triangle area reflects the possible need to underwrite or support these lost financial returns in order to encourage investment. Health related international

development initiatives, often underwritten by international institutional capital, are an example of such opportunities. This underwriting arrangement is described in greater detail in Chapter 7 - see case study on IFFIm.

**Philanthropic investors** could be:

- nudged to consider an alternative use of their resources, other than traditional investment and donation. By investing in social impact, returns could be anywhere from -100% (as in a donation) through to positive returns. (Such investors move upwards in the diagram from the bottom right quadrant towards or into the blended returns quadrant.) Again, this is not such a hard proposition to sell but requires a change of regulatory approach; it is currently considerably easier to present an opportunity to donate money than it is to offer an investment opportunity (Schwartz, 2011, Fletcher, L., 2011).

**Charitable Foundation investors** could be:

- nudged to allocate a small proportion of their endowment income towards social investment, in a way that aligns with their grant expenditure. This strategy falls under Programme Related Investment and Mission Connected Investing and was discussed in Section 4.5. It would therefore nudge a small proportion of Foundations' investments from receiving only financial returns to receiving blended returns. Again, this would help foundations to recycle their finances, as it could allow their grant strategies to be focused on those organisations that cannot receive investment (as discussed in 4.5).

These possible nudges are reflected in the adapted version of the chart, Figure 6.2b.

The Bridges Parthenon report (2010) states 'many impact-oriented funds cited their beginnings as impact first funds which later moved to provide improved financial returns'. Traditionally, their investor base was made up of foundations and HNWLs who were willing to receive below-market returns in exchange for certain levels of impact. As these funds were able to demonstrate their ability to generate market rate returns, institutional money started to flow and these funds eventually migrated to the 'finance first' segment.

Micro-finance investment and social housing have been examples of high social impact investments which gradually generated market level returns. It appears that investors determine that emerging markets offer more finance first impact investing opportunities (O'Donohoe, 2011). Risk-taking seed investors and philanthropists have played a catalytic role in nudging investments towards finance first, paving the way for mainstream investors take up the opportunities.

## 7 Social Investment Products: An Assessment

### Outline of this section of the report

In this part of the report we aim to get to grips with how well products and different investor priorities fit together. To this end, we have divided this section into four sub-components, as described below.

In 7.1, we identify the most important common criteria, expressed by investors. Not all investors *rank* these features equally but all investor types *consider* these as part of their investment decision.

In 7.2, we examine how well a selection of the social investment vehicles that are currently available meet these requirements.

In 7.3, we look more generally at the structural elements of an investment decision. Using the information provided by investors, we attempt to match up their stated preferences on a wide range of issues (such as level of engagement, or access to products) against the available vehicles. This produces a table matching investor type with known investment funds that could be of interest to different types of investors.

Finally in 7.4, we pick up on suggested product ideas that were generated by interviewees as a result of this research. We outline what certain products might look like as a guide for future development. These are very much the bare bones of products and are offered for further development, should they be considered useful by product developers. We discuss infrastructure developments within the social enterprise market place and conclude our findings on products.

The Annex provides full details of selected social investment products, either currently available or under development. We hope this will be useful to potential investors for ease of reference. We are sure this is not an exhaustive list, but is a very good start to indicate how innovative the sector is at finding solutions to investment challenges.

### 7.1 Key criteria in vehicles: rate of return, risk perception, liquidity, social impact

Our interviewees generally recognised that social investment propositions offered a blended return, combining financial and social returns in differing amounts. But, whilst acknowledging the need therefore to compromise their investment requirements, the most commonly expressed key criteria in an investment proposition were:

- expected rate of return to be assessed alongside the perception/mitigation of risk
- acceptable liquidity level
- clear social impact measurement

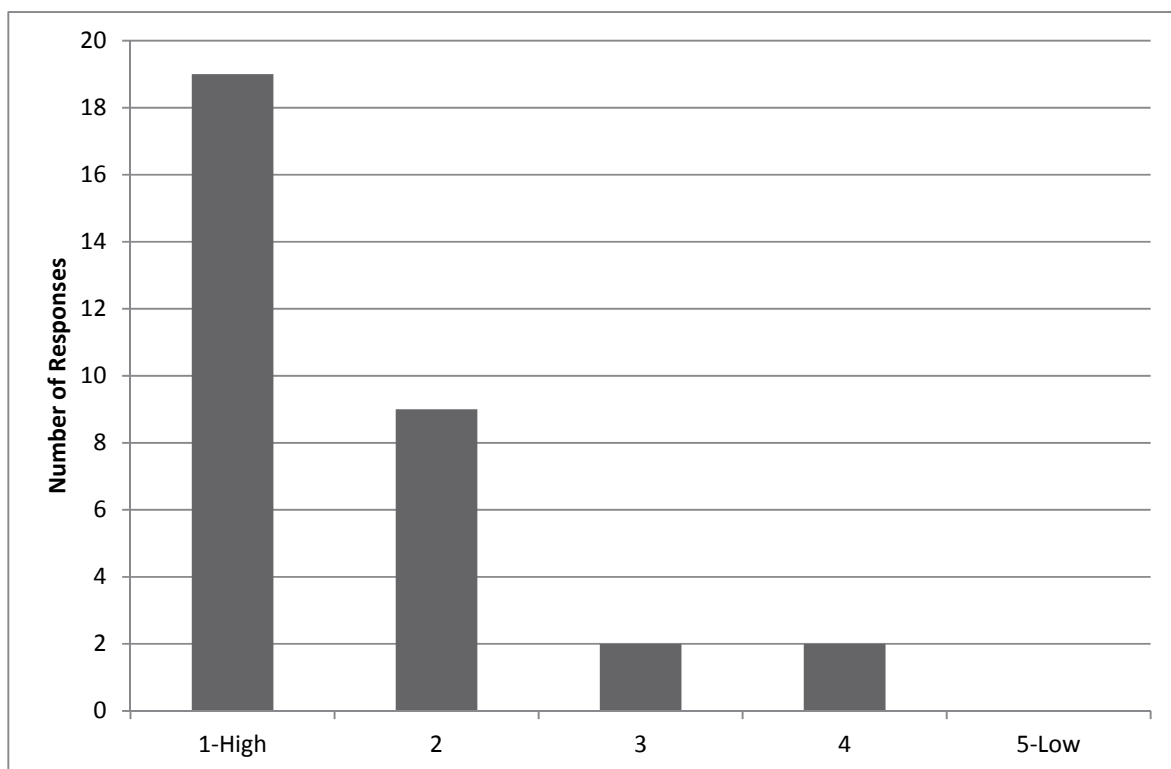
Not all investors rated these equally in their decision making process, as mentioned above, but they all identified these criteria as important determinants for their decision. We therefore analyse products in the light of these features.

### 7.1.1 Rate of return

Chart 7.1.1 gives the significance attributed to the rate of return in this sector by interviewees and the acceptable ranges ascribed to each group of investors. Even those who have lower acceptable rates, such as the charitable foundations, still rated the expected return as an important factor. Commercial (retail) banks in our survey, for example, considered the rate of return to be of high importance, but they were also prepared to accept a lower than ideal return when considering social loans or investment, so long as other factors were in place.

The rate of return that is acceptable has to be seen alongside the perception of risk of acquiring it. Interviewees expressed a greater interest in protecting the downside, or securing some minimal return, rather than undertaking social investments for risky but potentially higher returns. In other words, secure but low returns are seen as potentially more attractive than high but potentially insecure returns in this sector, as a general rule. The following two tables on rates of return and perception of risk reflect this.

**Chart 7.1.1: Table showing importance of expected rate of return from an investment**



Source: Survey undertaken in the course of this research

Type of Investor	Range of accepted rate of return on investments (a % p.a.)
Investment, Private and Retail Banks	0-9%
Investment fund managers	3-7%
Charitable Foundations	-100% (grant) to 7%
Social or Charitable Banks	4-9%
Social Financial Intermediaries	c.3-5% net
IFAs or investment consultants	aim for RPI +1%
Private Equity/ Venture Capital	12-18%
Pension Funds	c.7%+

Note: selected Foundations were broadly engaged in social investment, thus may not reflect the perspective of Foundations as a whole; Social Financial Intermediaries here include the perspectives of Social Private Equity and of brokers of social investment (i.e. not direct investors).

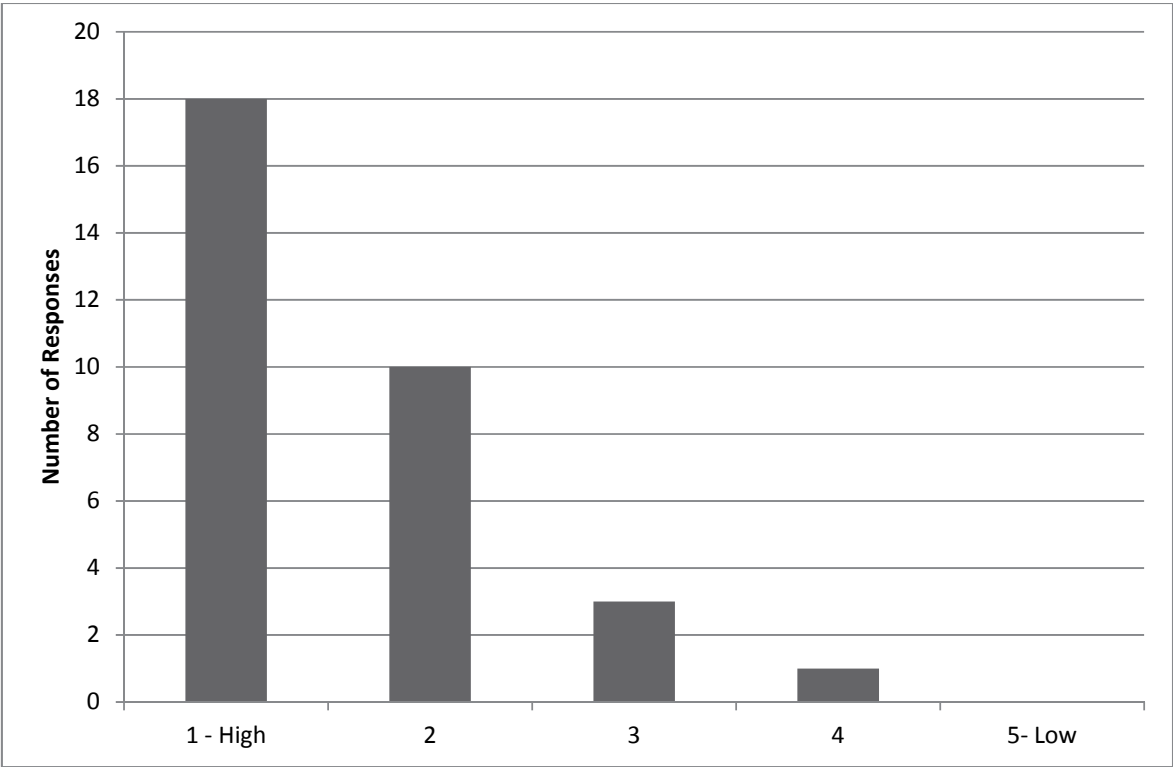
### 7.1.2 Risk perception

Overall, the protection of downside risk is a key component to be included in a social investment vehicle. It is particularly important in this sector, where returns are very rarely sufficiently high as to compensate for the increased risk. The risk of losing the principal invested was considered by most investors as unacceptable, unless it was a philanthropic proposition. This may reflect a more general reduction in risk appetite in investors' decisions and an appreciation of security of returns since the recent financial crisis. The types of risk to returns could be sub-divided into policy risks, developing country risks (where appropriate, e.g. in vehicles investing in UK and abroad), early stage risks and risks of mission drift.

However, the charitable foundations which were interviewed (and which were actively interested in social investment) were prepared to take these higher risks to test a new concept or to enhance their mission. This may not reflect the general position amongst Foundations, most of which do not appear to be actively engaged in Mission Connected Investment to date. However, in general, risk perception was ranked very highly as a key consideration by most investors, as shown in Chart 7.1.2.



Chart 7.1.2: Interviewees’ importance attributed to the perception of risk



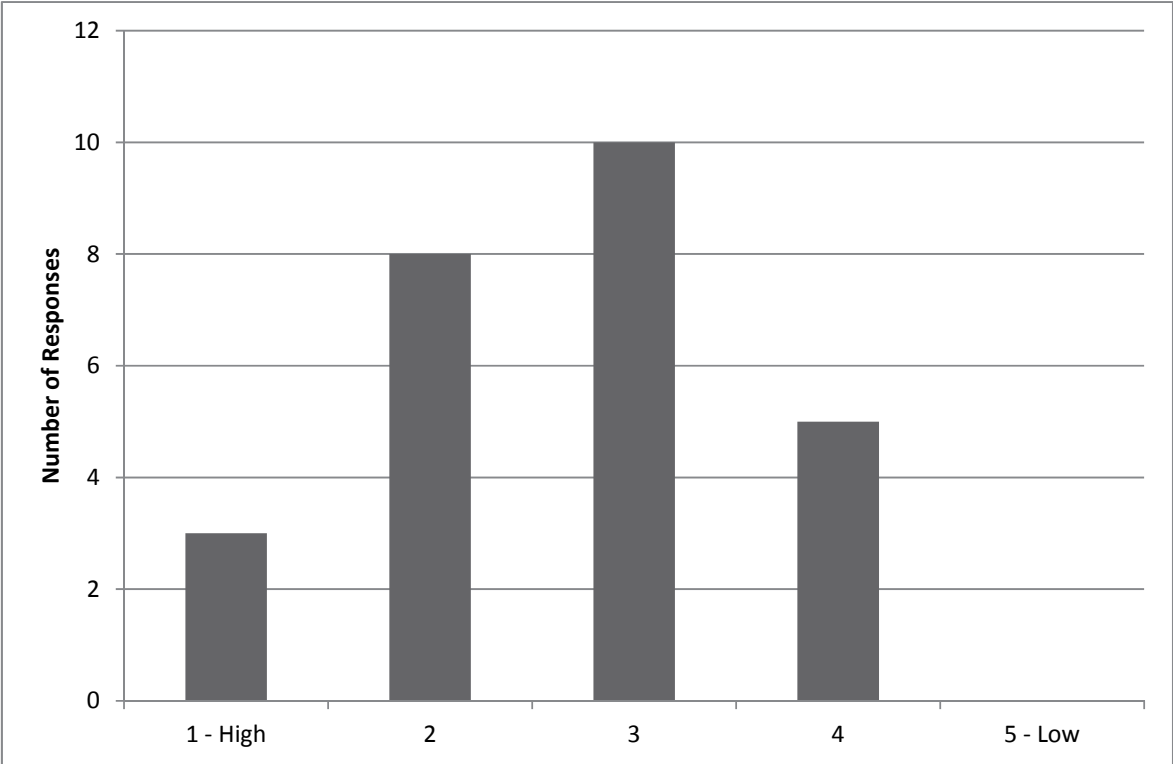
Source: Survey undertaken in the course of this research

7.1.3 Liquidity

A further point raised in interviews concerned the liquidity of social investment vehicles. Liquidity in mainstream markets is commonly linked to an opportunity to realise capital gains, which is largely absent in the social investment field. It is however, emerging in global impact investing, where microfinance, social housing and environmental funds have grown substantially in size in number and volume and become trade-able. Unlisted shares are problematic from a price-setting perspective although ethical shares, such as the Ethical Property Company, which trades on a matched-bargain market through stockbroker Brewin Dolphin, are an interesting UK experiment in providing some liquidity for small social enterprises. (See inset box below under Ethical shares). Unlisted bonds are even harder to fit into institutional investment strategies because of their underlying perceived illiquidity and lack of a market place to trade these, to date. Most investment fund managers are accustomed to instruments which offer constant liquidity and real-time pricing — this is hardly available in the social investment sphere.

Chart 7.1.3 shows the importance that investors attached the liquidity requirements. Whilst there were differences in view both within and across sectors,<sup>44</sup> in general, the distribution of views is relatively normally distributed within groups and across all investors.

**Chart 7.1.3: Interviewees’ importance attached to liquidity**



Source: Survey undertaken in the course of this research

**7.1.4 Social impact**

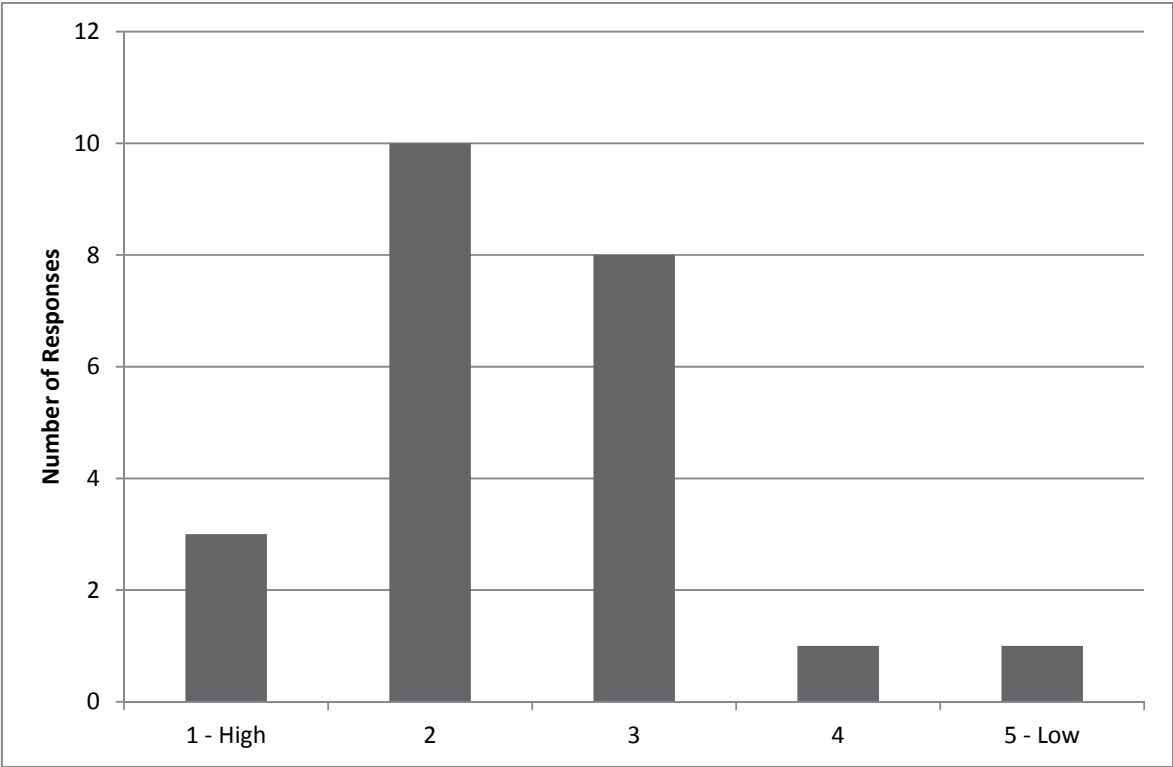
This issue of social impact measurement was as dominant in discussions with mainstream investors as with social investors. Ultimately, any investor interested in taking a ‘blended proposition’ wants to be assured that the intended social impact materialises, especially if financial returns have been sacrificed. Social returns aim, like a discounted cash flow analysis, to capture the impact of an action now and in the future. Their main value may best be assessed in terms of the opportunity costs saved, but quantifying these future returns requires analysis, forecasts, a degree of technical complexity and possibly some judgements. Given the immaturity of the social impact measurement as a discipline, it is hard if not impossible to provide the sort of rigour and accuracy which

<sup>44</sup> commercial banks do not rate liquidity so highly as they are experienced in holding assets, such as loans, on their books until maturity; charitable foundations varied in their views, but unsurprisingly, investment fund managers rated liquidity between 1 (high) and 3 (medium) in importance

is available in the financial markets; also, comparison of social returns across benefits generated is extremely subjective.

Chart 7.1.4.1 shows the relative importance attached to the measurement of social impact across different investor types. Most saw it as important in principle (rating 3 or higher) but in discussions, most investors referred to the difficulty in creating a reliable methodology to reflect this. One charitable foundation felt that the mission of the organisation spoke for itself and their engagement with it was sufficiently 'hands-on' that the social impact measurement was therefore of low importance.

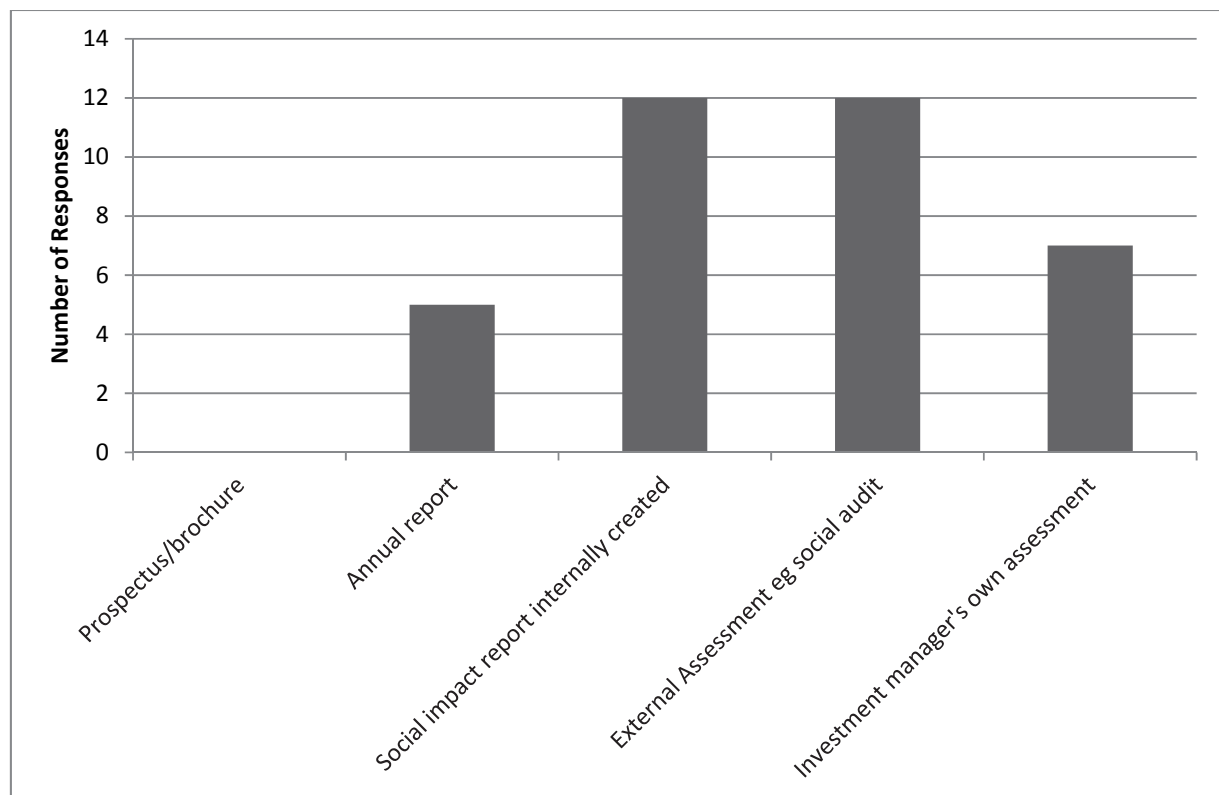
**Chart 7.1.4.1: Interviewees’ importance attached to the measurement of social impact**



Source: Survey undertaken in the course of this research

Investors’ preferences on social impact methodology ranged from requiring evidence of ethical criteria in an organisation’s articles of association at the point of due diligence, right through to requiring internal and external social audits at a series of intervals throughout an investment cycle. There was a common requirement to provide sector or sub-sector social impact benchmarks and one interviewee stressed the need for benchmarking and comparability across all organisations on the social impact generated.

Chart 7.1.4.2: How do you consider social impact is reliably best reported?



Source: Survey undertaken in the course of this research

### Social Impact Measurement methodology

As discussed briefly in Section 5, social impact measurement remains a challenging area in need of further development. Many institutional investors quoted the lack of a robust system as a barrier to engagement. Whilst investors were often clear on **what** they wanted to measure (value of intervention, causality between activity and impact, assurance that the impact could be created at greater scale), most were less clear about **how** it should be measured. Various indices against which change is measured, and confidence rating of one's own measurement, are all part of the experimentation to find better methodologies. The Social Impact Bond, for example, uses metrics which are very specific to the intervention targeted, and the rigor involved is reported to be attractive to investors. It may have set the bar high when investors come to assess future social investment propositions. The nature of the instrument, where financial returns (paid by the government) are linked to impact accomplished, makes this an obvious pre-requisite in this case. However, it is clear that not all impact can be measured in identical fashions, and we refer readers back to our recommendation in Section 5, that there should be investor forums developed to find the common ground between the level of data required by investors, and achievable by social enterprises, given the resource constraints faced.

Calvert Social Investment Foundation was an early developer of impact investment products, most famously the Calvert Community Investment Note.<sup>45</sup> In measuring its impact, Calvert considers IRIS framework important, and others such as: SMART Campaign - Client Protection Principles, Social Performance Task Force Metrics, CDFI Fund Community Investment Impact System (CIIS), in recognition that, to date, no one impact methodology fits all requirements. Calvert also tracks relevant key performance indicators and outputs (number of affordable housing units housed) and where possible some outcome metrics (number of individuals housed). Other investors use a growing array of systems, both externally and internally developed.

In the UK, Bridges Ventures, for example, uses its IMPACT scorecard. Its social impact is across all its funds is recorded using this methodology and is reported annually (Bridges Social Impact Report, 2010). Importantly, the investors into these funds who were interviewed in this research found this methodology met their requirements. Successful enterprises to date, such as HCT (see case study) use a simple set of targets and measure performance against these. BlueOrchard, a leading European and international commercial micro-finance investment management firm, uses its proprietary SPIRIT scorecard (Social Performance, Impact reporting & Intelligence Tool)<sup>46</sup>, an EIRIS based methodology. A range of networks and methodologies help to inform this process including the NeXii portal, the Social Return on Investment (SROI) network, the Global Impact Investing Network (GIIN) and many others.

ClearlySo takes the view that differing national characteristics makes it improbable that one size will fit all, but that in the short run the market also benefits from continuous innovation in social impact metric systems.

### **Wider application of the social impact methodology**

The scope for creating and measuring social impact does not remain limited to the field of social enterprise and the social sector. The commercial companies are also interested in determining their social and environmental impact from their activities. This creates a real opportunity for social and commercial enterprises to work together on the basis of common goals.

Social Return on Investment (SROI) is one of many analytic tools to measure and account for a broad concept of value to incorporate social, environmental and economic costs and benefits into decision making. SROI aims to provide a fuller picture of how value is created or destroyed by assigning a monetary figure to social and environmental value which is created. A significant aspect of SROI's work is to provide this analysis to commercial companies, globally. This gives room for optimism that impact can eventually find its place as the third dimension in investment decisions (after risk and return).

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<sup>45</sup><http://www.calvertfoundation.org/invest/how-to-invest/community-investment-note>

<sup>46</sup> See *Impact Assets 50* for further information on impact investment opportunities and details of their social impact methodology: <http://www.impactassets.org/impactassets-50/2011-impactassets-50>

## 7.2 Analysis of Existing Investment Vehicles – How do They Fit with Investors' Stated Preferences?

Firstly we summarise the main vehicles that are available and highlight with a slide- rule, how well they match against the key criteria that investors perceive to be important. We then look at ways to address any issues that the vehicle poses.

### Current investment vehicles

Some of the main current investment vehicles for social investing in the UK are:

- Social Impact Bond
- Scope Donor Financing Model
- Limited Partnership structures used by:
  - Bridges Ventures
  - Big Issue Invest
- CAF Venturesome
- Allia Bond
- Truestone Impact Investment Fund
- Ethical shares (such as the Ethical Property Company)
- Generic assets used for social investment such as Social Bonds, Quasi-equity (generic). There are also several social banking options which have the structure of a deposit account.

### 7.2.1 Social Impact Bond: a possible alternative structure of the Social Impact Bond

#### Social Impact Bond

**Description:** A Social Impact Bond (SIB) is a contract with the public sector in which the public sector undertakes a commitment to pay for improved social outcomes above a certain threshold that result in public sector savings. These outcomes and returns are used as a basis for raising investment for prevention and early intervention services which improve social outcomes. A pilot SIB was introduced in 2010 (developed by Social Finance)<sup>47</sup> to tackle recidivism rates in Peterborough.

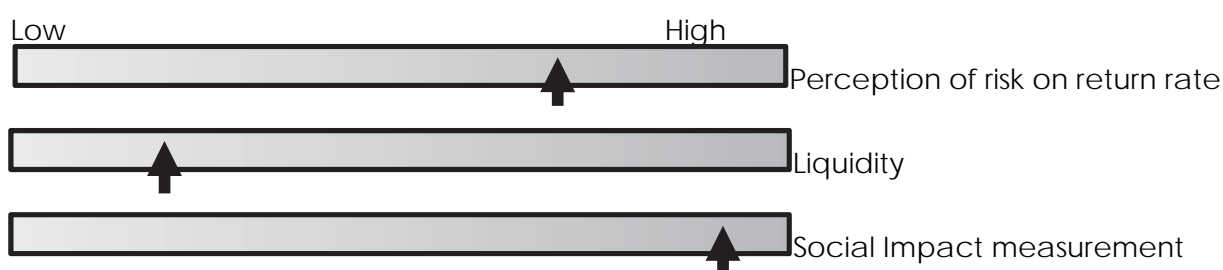
Payments to investors will take place 22 months after the end of each cohort group of offenders has been released, and will be made once there has been a 10% reduction in occurrences of conviction, when compared with the other cohort groups. If a 10% reduction in conviction events has not been detected for any of the 3 cohorts, at the end of the term, the 3 cohorts will be evaluated together. For the larger combined cohort size of 3,000 prison-leavers, a 7.5% reduction in conviction events would be perceived as statistically significant and a payment would be made for any reduced conviction event for which investors have not already been paid. If the measured reduction is less than 7.5% across the 3 cohorts, no payment is due under any circumstances. A cap on outcome payments limits investor returns to 13% in the event of strong performance. Various structures for future SIBs are under consideration. The following details apply to the existing pilot scheme.

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<sup>47</sup> <http://www.socialfinance.org.uk/work/sibs>

Key features	Social Impact Bond
Legal structure of pilot SIB	Limited Partnership, closed fund
Investors to date	17 charitable foundations/HNWIs
Value of pilot fund/ instrument	£5m
Investment Period	£5 million will be drawn evenly over 6 years. Returns in years 4, 6 and 8

Social Impact Bond scores against key investor preference



### Social Impact and their measurement of social impact

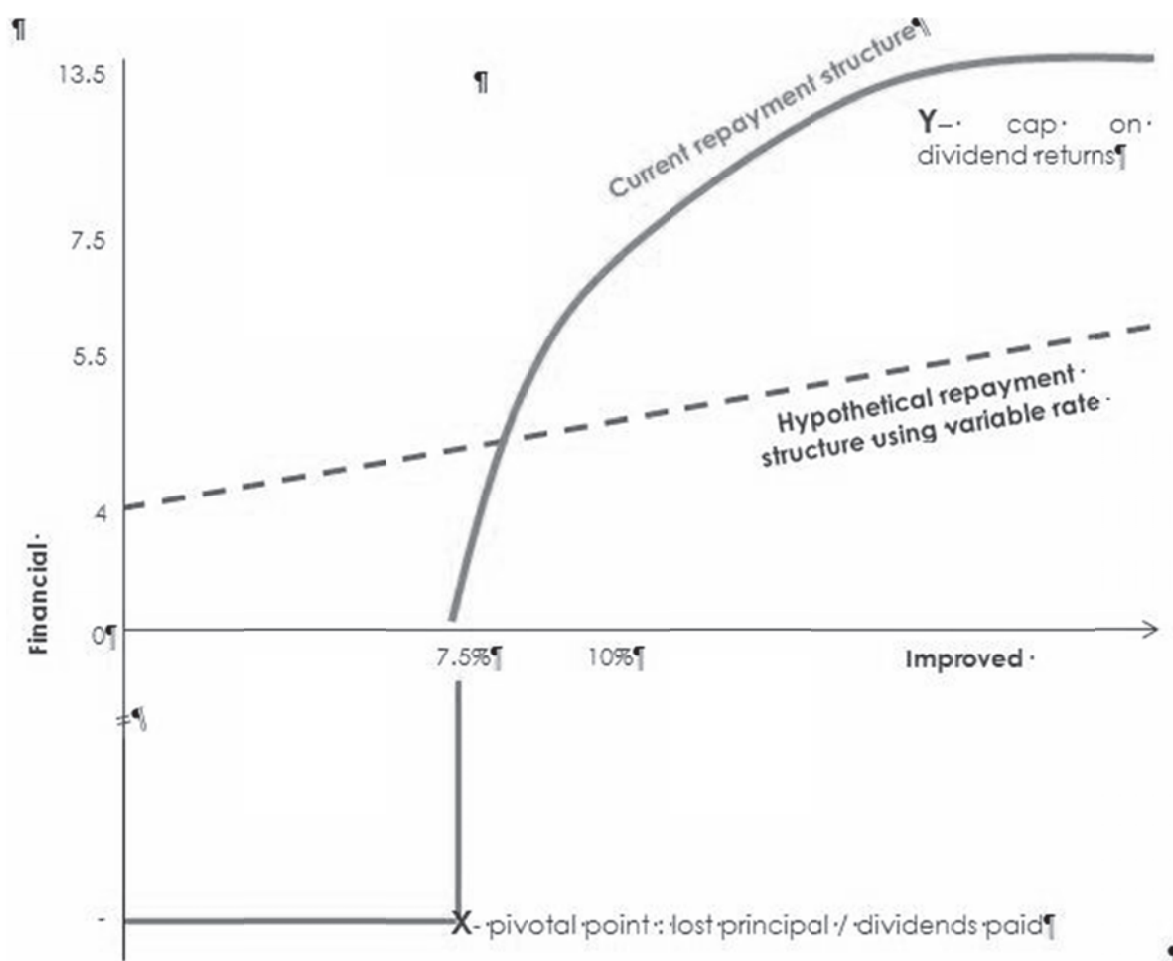
The SIB performance and impact measurement is based on a highly complex and sector-specific group of metrics, which involves a comparison in the reduction in reconviction rates relative to the experience with a control group of short-sentence prisoners in the UK. This level of impact data meets investors' requirements for proof of impact and has set the bar high for other investment vehicles to measure their social impact with comparable rigour.

### Social Impact Bonds and their level of risk

Of all existing investment vehicles, the SIB was, along with Bridges Ventures Funds, the best-known among mainstream investors, having captured the public's imagination here and abroad. ClearlySo believes this is due to the single great innovation of the instrument—securing a promise from the government to reward investors into social interventions a portion of budgetary cost savings. There was real interest in the concept, the methodology and the approach to the instrument. However, the perceived downside risk was seen as problematic for many investors, particularly in a pilot phase in which the risk of losing principal was difficult to assess.

Figure 7.2 maps out the repayment schedule as it is operating in the Pilot phase. Within this graph, we illustrate an alternative hypothetical structure in response to interviewees' stated preferences to reduce the downside risk on the SIB proposal. We illustrate a variable bond with a maximum return rate of 5.5%. This removes the precipitous point X, at 7.5% impact point, below which all the investment principal is lost, and the return is nil.

Figure 7.2: Social Impact Bonds current and proposed repayment schedule



### 7.2.1.1 An alternative repayment schedule

The chart illustrates an alternative scenario - to provide a variable rate return (with a guaranteed minimum) which could maintain the link with impact whilst removing the downside risk. It would also be easier to structure once a track record of the performance of a themed SIB had been built up. Another alternative is to underwrite the potential losses, which would occur if impact achieved was less than 7.5% of current rates.

#### One size does not fit all

It is important to say that this 'investor preferred' profile will depend on the target investors. If, for example, the SIB aims to pilot another similarly scaled initiative, it may seek venture philanthropy capital or socially motivated investors, who may not prioritise the mitigation of risk in the same way as institutional fund managers. In fact, it could



even be preferable to limit the investors to those with the risk profile required, rather than attempt to attract a wider investor base, and threaten the underlying concept. We are therefore not suggesting that SIBs must change to fit this profile; we are merely pointing out that City institutions' risk mitigation requirements may differ from HNWLs or foundations' requirements. The existing pilot SIB targeted charitable foundations which were prepared to be early adopters and take on required risk in order to test an interesting new concept. Their knowledge of the criminal justice sector informed their judgement on the likely outcomes of the intervention.

However, should the SIB look to attract a wider investor base, there are at least two possible ways of achieving this gentler risk/return/impact profile - as discussed below:

- **raise five times as much money as is required;** invest 80% in a cash equivalent / deposit or investments with a 'safe' rate of return; use only 20% of cash raised to deliver the intervention; pay all investors the principal plus flat rate of interest (or variable) from the deposit at the end of the intervention period, irrespective of outcomes. The disadvantage of this is that it takes much longer to raise the finance to begin the intervention, with concomitantly reduced impact, and it potentially removes the conceptual link with impact.
- **secure an underwriter for the intervention;** the SIB pilot intervention in Peterborough prison was secured by seventeen investors, predominantly charitable foundations. These Foundations will be paid by the Ministry of Justice and the Big Lottery Fund through the budget savings generated from the intervention. As the pilots provide a track record of savings, the need for guarantees should decrease and the willingness to provide them should increase. Chapter 9 discusses issues arising from arranging a public sector based investment vehicle where multiple commissioners are involved.

In looking at possible investment vehicles that may be developed to fund public sector spin-outs, this consideration of downside risk is critical. The BSB, possibly in partnership with other investors, would be well placed to provide this type of guarantee in other Social Impact Bonds or in a pooled investment fund targeted to support public service organisations. Such a 'tiered finance' approach is used to fund the International Finance Facility for Immunisation. This is managed by the World Bank and underwritten by various governments and Gates Foundation: (See case study in following Box). Other examples in the UK of social investment funds that have used institutional funds to lever in additional capital include the Key Fund, which was established with government and EU structural fund support to provide start-up and growth finance in specific EU priority areas of the UK<sup>48</sup>. Mainstream investments were levered in above the junior risk which was provided by different governments' funds.

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<sup>48</sup> Yorkshire and Humberside was a designated Objective 1 area and received additional EU structural funds up until 2005.

- **Tax inducements to attract HNWLs to invest in SIBs**

Assuming that future SIBs, with a focus on health or social care (or other) interventions, will seek socially motivated HNWL individuals as the investor base, there may still be a need to mitigate the risk to the investor where there are such complex needs and commissioning structures. Tax incentives could play a role here.

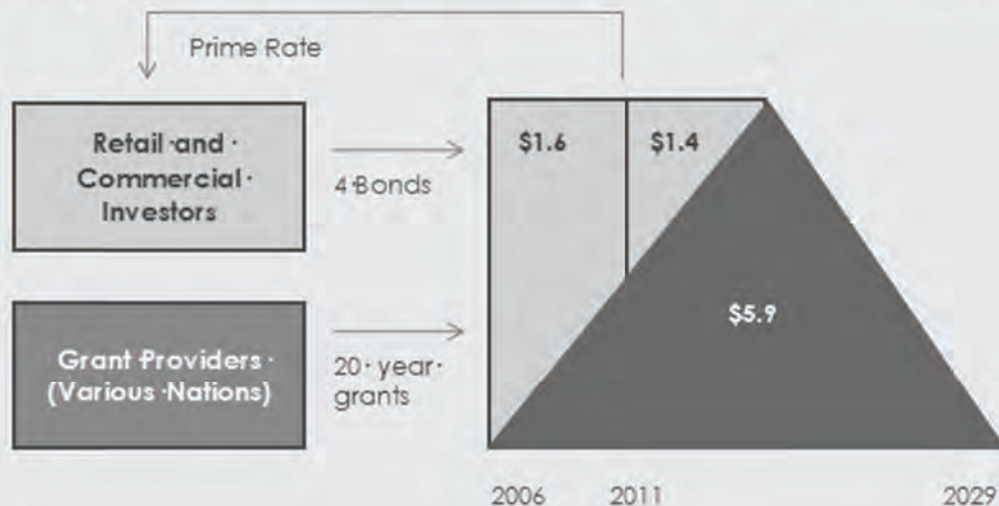
Tax incentives could cover the structure, such as a much-discussed social Venture Capital Trust (which would qualify under the very favourable VCT regime) but the maximum investment would be £200,000 and there are a series of restrictions and limitations which could make this less appropriate in some circumstances. Alternatively, government could provide tax relief on losses incurred from such an investment, as the initial investment was specifically targeted at seeing if reductions to the public purse could be made (Elliott, 2011). This fits with the general business tax principle of 'no risk=no relief', but would be extended to include high 'risk=some relief' (Heaney, V., 2010).

Current tax provisions makes it theoretically easier to construct vehicles to generate tax reliefs for individual investors into social investment (through the use of EIS and VCT structures) than it is for any institutional investors (although the Community Interest Tax Relief is open to corporations under strict geographical, sectoral and timing conditions). It is also worth noting that foundations, which potentially offer a key source of capital for the sector, lack any fiscal incentive to invest. This is particularly relevant where a HNWL either establishes or invests into a foundation. Section 7.2 discusses the issues around constructing a VCT fund.

### 7.2.1.2 Tiered financing arrangements; case study IFFIm

Example of tiered finance as used in International Finance Fund for Immunisation (IFFIm)

Example of tiered finance as used in International Finance Fund for Immunisation (IFFIm)



Source: Adapted from Bridges Parthenon report: Investing for Impact, case studies across asset classes

#### Social Impact:

With money from IFFIm and \$1.5bn grant from Gates Foundation and many other donors, Global Alliance for Vaccinations and Immunisations (GAVI) has prevented 3.4 million premature deaths, though raising vaccine coverage in 70 poorest countries

#### Financial Impact:

IFFIm has raised \$3bn in bond offerings to date 2011): benefitting from its partnerships with governments and commercial banks (e.g. HSBC in UK), its bond being listed and AAA rated, it offers improved returns over sovereign bonds to date and provides investors with a financial and impact investment.

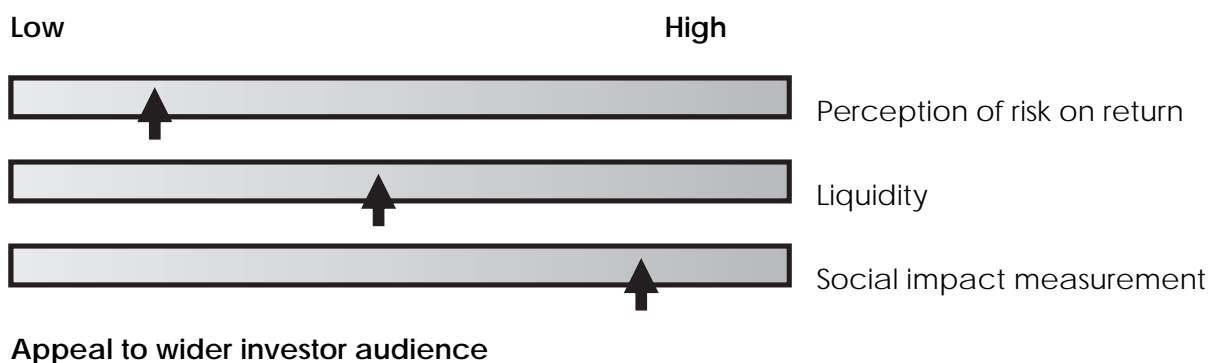
### 7.2.2 Scope Philanthropic Loan Financing Model

**Description:** Scope, a leading UK disability charity has raised almost £1.8m to build 15 tailored homes, which will be maintained through revenue from public service contracts. They offer a 'philanthropic loan' to sophisticated investors, philanthropists or charitable foundations which make both a donation and a philanthropic investment on a 1:4 ratio.

The tiers of the vehicle comprise: a gross donation, gift aid at basic rate to the charity with tax relief at higher rate returned to the donor, and a philanthropic loan. The 'donor/investor' is repaid the capital in 3 years through funds raised from the sale of out-dated buildings. The tiered package enables the charity to secure a commercial mortgage for the remainder of the cost of the new building, on a 10–15 year basis from a bank. Over 90% of the funding has already been secured.

**Key features:** tiered financing structure: donation, gift aid& tax relief tiered in a ratio of 1 net donation to 4 parts loan. This creates an efficient package on which to raise commercial loans, meaning that every £10 net invested creates £100 of value for the charity.

Key details	Scope Philanthropic Loan
Legal structure	Donor loan, but asset-backed, based on sale of land
Investors targeted:	High net worth individuals, other sophisticated individual investors, charitable trusts
Value of fund	Total £1.8m 100 individuals sought to raise £7,000 loan, £1,750 net donation (£3,500 including Gift aid and tax relief)
Cost to donor / investors	£1750 net donation (£2,800 gross - £1050 tax relief) £7,000 loan (plus lost interest and inflation)
Return on philanthropic loan	0%
Return on commercial loan for build	3-6%
Investment Period for 'philanthropic loan'	3 year loan period, repaid when old building is sold



This type of tiered product could be made available in future through private banks, for their venture philanthropic clients, or social and charitable banks could encourage their depositors to engage with this as potential donor investors. However, this does not deliver market returns and is therefore not or intended to be offered to SRI investment fund managers or pension fund managers to include in their mainstream portfolios.

Financial and administrative costs to the scheme need to be considered if this type of product is to be constructed for the retail market rather than the sophisticated investor market, as FSA marketing regulations would then apply.

### **Product design implications**

This model could also be used to fund non-philanthropic but high risk ventures to attract investors who are used to financing start-ups in the social or commercial sector. One venture capitalist said:

*" this model is significantly more efficient than a traditional donation-based model".*

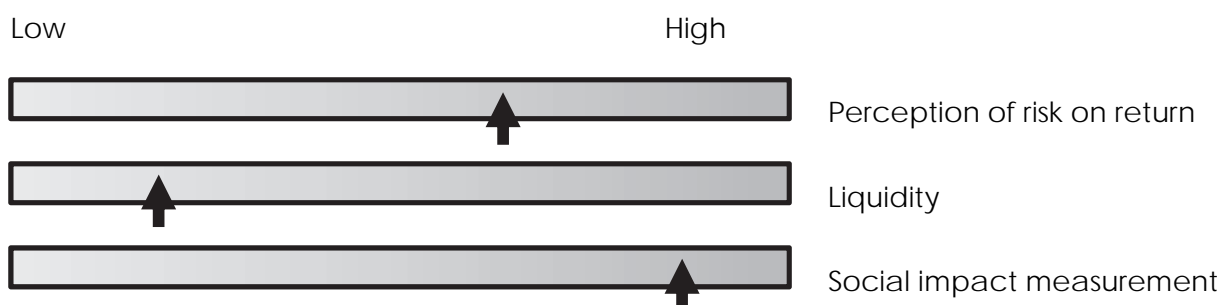
This highlights the use of innovation in the sector which has applicability beyond social impact investing and its success suggests that variations of this type of arrangement could be used in other product designs targeted at HNWI, foundations, Corporate Social Responsibility and Corporate Social Innovation initiatives of companies.

The asset backing of this investment makes it particularly secure and attractive and should be considered in any replication of this type of product for other uses.

### **7.2.3 Social Venture Funds – Bridges, Big Issue Invest, CAF Venturesome**

**Description:** Established during the last decade using a private equity model for blended returns on investment, these private equity type funds are structured as limited partnerships. They are closed funds and money is committed for the length of the fund (typically around 10 years). CAF Venturesome is funded from donor accounts and foundations, and provides working capital and unsecured loans to social enterprises and charities. Big Issue Invest LP and Bridges Social Entrepreneurs Fund provide growth capital to social ventures. Bridges Ventures also runs two 'finance first' social venture funds, which are investing in deprived areas and one sustainable property fund. The following information refers funds supporting social enterprises and charities.

Key Details	Social Venture Funds
Legal Structure	Limited Partnerships <sup>49</sup>
Investors and donors to date	Charitable foundations, institutions and HNWI's, commercial banks investing into these (This is a recent occurrence, with examples being, Deutsche Bank into Big Issue Invest Social Enterprise Investment Fund and J. P. Morgan Social Finance Unit into Bridges Social Entrepreneurs Fund)
Value of Funds	Bridges Social Entrepreneurs Fund: £11.75M Big Issue Invest Social Enterprise Investment Fund: £7m CAF Venturesome: £10m Resonance Social Care Property Fund: target £20m Finance South East & Resonance: target £2.5m
Investment Period	Fund period is on average 10 years; Income distributions paid out annually if accrued.
Investment vehicles used	Quasi-equity, equity, loans, fixed and variable rate bonds, bridging loan finance and underwriting from Venturesome



### Perception of risk on return

The donation base of some of these funds has meant the perception of risk on return has not been critical to date. As more impact first investors look to invest and receive returns, (in 2011 two commercial banks invested into Big Issue Invest and Bridges Ventures Social Entrepreneurs Fund), this changes the requirements of the funds. Average return rates sought on these funds are 3 -5 % net. Venturesome has greater freedom on this score, seeking to gain a c 0% return over the portfolio.

### Social Impact measurement and engagement levels in Social Venture Funds

<sup>49</sup>CAF Venturesome fund operates as an open ended evergreen fund,

These social venture funds meet particular investor preferences on several fronts. They focus heavily on impact measurement across the portfolios and the fund managers are actively engaged in helping these businesses reach their blended returns, seeking seats on the board and providing a range of mentoring and pro bono support. Deutsche Bank, for example, aims to supplement its £450,000 cash investment into Big Issue Invest last month with support from its employees and contacts. Bridges Ventures has developed a strategic partnership with Monitor Group to provide pro-bono consultancy and advice to new investees. Typically, these funds are highly engaged in supporting their investees.

CAF Venturesome has seen steady demand, averaging two to three investments per month. Investment for growth capital has, to date, been a problem owing to a shortage of investable enterprises to lend to, although interviewees expressed an up-turn in back-able businesses of late. In fact, all three funds have made investments in the last two months, into two different enterprises. Gradually, these funds are creating their own distinct portfolios, reducing the replication of investment holdings.

CAF Venturesome uses donor funds for investment and as such has flexibility over its rates of return across the portfolio. It seeks to maintain its capital base, broadly. It is also highly engaged with its investees (but would not seek seats on Boards); it provides active support, often around business plan development and market opportunities as organisations seek external financing. They offer working capital (around two thirds of its lending) support for business transition and growth capital.

Resonance is developing two investment products using the limited partnership structure. Matrices for all these funds' details are presented in the Annex of the report.

### **Product design implications**

These funds have limited liquidity as they are closed for the period of the investment. This makes certain investors, such as SRI fund managers, unable to invest easily. Investments may be tranching, but pre-committed. SRI investment fund managers suggested that the creation of a unit trust alongside the limited partnership funds would allow greater opportunities for SRI engagement in the fund. However, the funding requirements of the investees may then be at odds with those of the investor; the need for long term patient capital offer could be difficult to square with a unit trust's tradeability. Social private equity funds have shown themselves to be attractive to those investors which can accommodate some illiquidity, but it is not designed to suit all investors.

### **Variation on Limited Partnership structure for social enterprises:**

**Social Enterprise Limited Liability Partnership (SELLP)** (Lloyd, 2011). This structure is a recent suggestion designed to tackle the need for pooled funds from multiple investor sources with different requirements, whilst ensuring mission is maintained. This could establish special purpose vehicles allowing charities and private investors to pool their investments, but each partner remains individually liable for taxation. The Charity could hold the golden share to ensure mission focus.

### 7.2.3 Allia Bond

**Description:** a fixed return investment offering up to 10% interest at the end of the five year term in which the arbitrage is donated to the charitable cause chosen by the investor. Subscribers of the bonds may also choose a lower or zero return on maturity to give a further up-front donation to their cause.

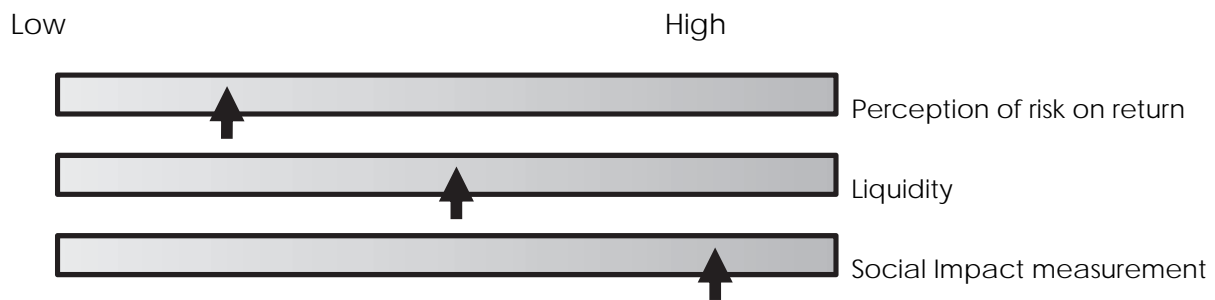
The present value of the repayment at maturity is loaned at a fixed rate to an AA rated social housing provider<sup>50</sup>; after a small deduction for costs, the remainder is donated to the investor's chosen charity. At the end of the five year term, the housing provider repays the loan with tax free interest. This covers the repayment of the bond at the chosen rate of interest. The amount invested or donated is calculated according to the rate on the loan to the housing provider and the rate of return required by the bond holder (they can 'donate' all their potential yield or they can claim all up to 10% on maturity - the equivalent of simple interest at 2% each year).

Key Details	Allia Bond
Vehicle Type/ legal structure	Bond at a fixed rate of interest, selected by the bondholder
Investment Period	5 years. Current open offer up to August 2011 with closure in 2016, future offers to be made in regular cycles
Value of funds raised to date	£16m since 1999 in bonds focused specifically on raising funds for employment and enterprise
Investor interest	charitable foundations, HNWI and corporate bodies, all registered in the UK
Minimum payment	£100
Rate of return	Subscribers may select 0, 5 or 10% after five years
Tax liability	Returns over the principal subject to UK tax; there is no gift aid attributed to the donated element of the bond since no tax is deducted.

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<sup>50</sup> Although this report does not consider social housing within social investment (as described in Section 2), it is integral to the Allia Bond, which is an interesting example of 'tiered finance' so is discussed here.





*"Now more than ever charities need unrestricted money which the Bond provides upfront"*

City Bridge Trust

### Rates of return

The bond scores highly on the key criteria identified by investors. Social housing has proven to be reliable in providing the necessary returns required (partly owing to regulation within the industry). The sector also has large financing needs so is able to absorb Allia Bond lending.

### Liquidity

The bonds are transferable which helps to add to the liquidity. Five year holding is considered acceptable for the target group of investors.

### Social impact assessment

The organisations which receive the donations provide their own regular assessment of impact. Some organisations may choose to conduct more in depth assessment through Allia's own separate company, Future Business, which is accredited in the use of Social Return on Investment (SROI) methodology.

This bond provides an additional fundraising tool for charities that are unable to access social investment directly. It also enables investors to use their capital securely to benefit their chosen cause without having to take credit risk on that cause.

### Product design implications

The bond is particularly appealing to a range of investors not previously discussed in this report – the corporate investor – seeking to diversify their portfolio of investments on their surpluses, whilst helping a charity of their choice. Examples of corporate holdings of Allia bonds include the FTSE100 companies, Arm Holding (£2.5m holding), Greggs (£0.5m holding), TTP (£2.5m holding) and HSBC (£20,000 holding).

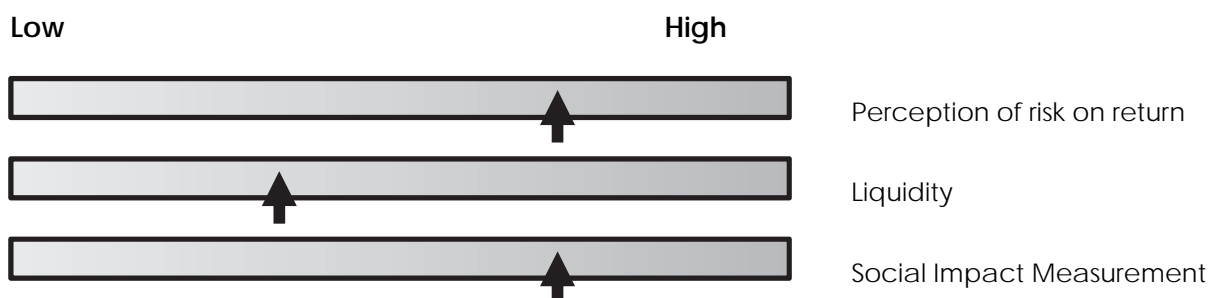
The Allia bond is not aimed at providing 'finance first' returns to traditional investors but at individuals, foundations and corporations looking to hold the value of their loan whilst donating simultaneously. This product is perfectly designed for the target audience it attracts. Private bank wealth managers suggested that inclusion of tax reliefs into social investment products generally would add to their attraction for HNWI clients.

### 7.2.4 Truestone Global Impact Investment Fund

**Description:** The fund, launched in March 2011, invests in companies and other investment vehicles with a quantifiable social or environmental impact. It engages in several impact investing sectors including social housing, environment, education micro-finance, both in UK and globally.

Key Details	Truestone Global Impact Investment Fund
Fund Structure	OEIC, FSA registered, constructed of 50% private equity, closed, and 50% open
Total fund size	£10m
Expected rates of return	c 8.5% net to investors
Size of investment	£25,000 minimum; no maximum
Target investors:	HNWIs and institutional investors

#### Truestone Global Impact Fund's fit with investor preferences



#### Risk adjusted rates of return

Many of the investments in Truestone Global Impact Fund are held in companies abroad in emerging and unstable countries. There are therefore political, currency and other external risks which make the capital at risk. For this reason, there is close monitoring on the ground by the investment house on the companies' performance and the policy issues in country which might affect this. The portfolio is diverse, in terms of the sectors covered and geographically, in order to spread the risk on overall returns. The fund opened in March 2011.

#### Liquidity

The level of liquidity is not as strong as the public equity only Open Ended Investment Company (OEIC) because of the private equity component of the fund. The fund is priced monthly. The fund aims to offer a long term investment but it is structured to offer an element of liquidity to investors. This is provided through redemption dates made available on a monthly basis with 6 months' prior notice after an initial lock-in period.

The private equity component will expect to gain its returns within the 4–7 year time period. The fund does not have a defined lifetime.

### **Social impact measurement**

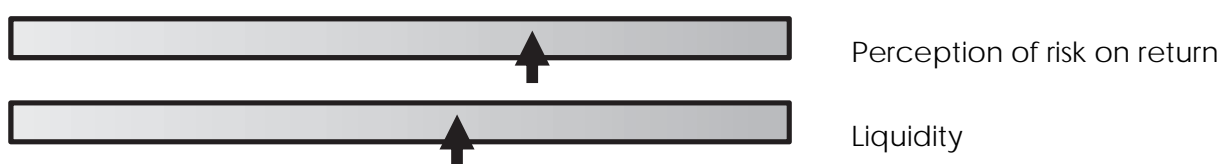
Social impact of the fund is provided in the following way: alongside the annual financial audit of fund performance Deloitte will also be auditing statements on the 'social returns' of the fund as measured through collation of numerous impact Key Performance Indicators (KPIs) from the portfolio holdings of the fund. Additionally, Truestone's investment team monitor impact KPIs of existing investments through regular monthly or quarterly reporting from investments.

### **Product design implications**

Product designers of this fund found they were limited by the range of social investment opportunities offered within the UK. This has meant that the fund offers a globally diversified fund, with the associated risks discussed above. This reinforces the need for social enterprises in the UK to offer more varied and appealing investment opportunities. Investors interviewed felt that public service provision may offer new UK social investment opportunities but these need to be made into attractive investment propositions. This is discussed further in Chapter 8.

## **7.2.5 The Ethical Share Capital**

Social equity comprises listed and unlisted shares in social enterprises or social businesses. Listed equity usually provides greater liquidity, and therefore offers more risk mitigation than unlisted shares. Ethical shares are currently most commonly traded using a matched bargain process. Whilst liquidity therefore is available in principle, it is limited in practice, in part because of the concentration of shareholders within the ethical investment marketplace. The lack of liquidity in the marketplace increases the perception of risk on return. Companies limited by shares with the CIC status provide confidence to equity investors of the commitment to reinvestment of profits, but it caps the dividends that investors can receive from equity investment at 20%.



It is not possible to generalise on the social impact measurement for all ethical shares.

However, the following case study of Ethical Property Company exemplifies successful capital raising through equity offerings. The founder of this company is now developing the Ethex trading platform, which aims to encourage trade between shareholders of social equity. The Social Stock Exchange also aims to act as a trading platform for those social businesses with a market cap above £10m (see 7.4.8).

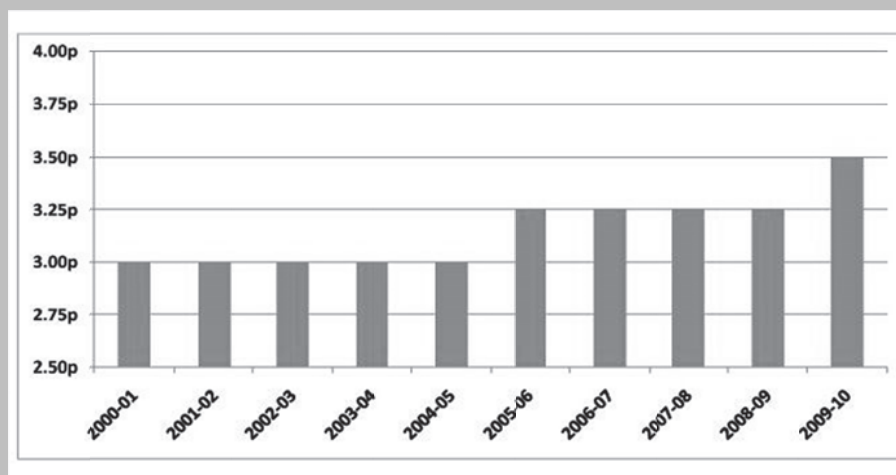


### Case Study: Ethical Property Company

The Ethical Property Company began trading in 1998 to meet the property needs of Social Change Organisations across the UK. It now owns 15 Centres in England and Scotland valued at over £15.9 million and housing over 200 Social Change Organisations. The company offered its first share issue in 1999, followed by further share issues in 2002, 2006 and 2010. All of these were fully subscribed. It has also established sister companies in Belgium and France and owns or manages centres in Brussels, Namur and Lyon.

The Ethical Property Company offers investors the chance to make an ethical investment that offers the potential for financial, social and environmental returns.

The company has paid a dividend every year for over ten years; 3 pence per share in April 2000, 3.25 pence per share in April 2005 and 3 pence once more in April 2011.

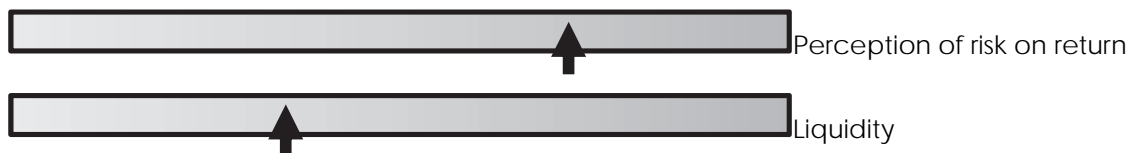


The Ethical Property Company's latest share issue raised £3.75m to provide office space to ethical businesses and will fund a centre for human rights and social justice in London. The share issue was not open to the public, but to existing shareholders and professional and high net worth investors. The investment offers a dividend of 4%. Investors included large foundations, ethical investment management companies, customers of ethical retail banks and city fund managers. The share issue was sponsored by Triodos.

Shares of Ethical Property Company have been traded on a Matched Bargain Market. The company is committed to improving the efficiency and liquidity of this system to assist shareholders wishing to sell their Shares when they need to. To this end, the CEO and Founder of Ethical Property Company is now developing Ethex, an on-line platform for ethical share trading (see Section 7.4.8).

### 7.2.6 Social Bonds (fixed or variable); Quasi-equity

Quasi-equity is a proxy for share capital which is increasingly used in social enterprise investment, particularly where equity itself cannot be offered (e.g. in the case of charities). Quasi-equity, usually provided in the form of revenue participation agreement, offers investors benefits linked to increased turnover generated as a result of the investment. It is increasingly offered by social fund managers. It is still too early to see the extent to which quasi-equity matches well the needs of investors and investees, as most investments using this have not reached their full term yet. In general, quasi-equity offers the potential to generate high returns if the investee is successful, but unless specifically embedded into the deal, the risk associated is not mitigated by a minimum guarantee return. As discussed earlier, institutional investors broadly prefer flatter more certain return profiles when investing in social enterprises, as would be offered by a fixed rate bond.



It is not possible to generalise on the social impact measurement for all quasi-equity.

Social bonds can be listed, or unlisted, fixed rate or variable, asset backed or unsecured, fixed term or variable term. Many bonds used by the social sector are not rated or listed and this can make them hard to trade. They tend to be bespoke between investor(s) and investee.

These vehicles can be used in conjunction with other forms of loans or bonds, as demonstrated in the following case study of HCT.



### **Case study: HCT Group**

#### **Finance raised using fixed loans and quasi-equity social loans: HCT Group**

HCT Group is a registered charity. It raised £4m of growth capital through offering two parallel 5 year loans. One offered a fixed rate of 5% return; the other was a quasi-equity (called 'social loan'), which linked returns to increases in revenue over an agreed threshold. Social targets were also established as part of the package. Those who invested in the social loan also had to invest in the fixed loan. Bridges Social Entrepreneurs Fund acted as the cornerstone investor. It invested on a 2:1 ratio of social loan: fixed loan. Big Issue Invest also invested in both the fixed rate loan and the social loan. The third investor was Rathbone Greenbank, an investment house with an interest in social and ethical investment, which invested in the fixed bond on behalf of their private clients. The fourth investor was the government's Futurebuilders Fund which also invested in both types of loans.

Lessons learned: There are innovative ways in which corporate finance tools can be adapted to fit the needs of different investors to support social and charitable enterprises.

### **7.2.7 Conclusions on products**

In conclusion, we can see that the existing social investment markets broadly meet their target audiences' requirements very well. The weakness is not in the suitability of the existing products on the market to meet target investors' needs. The problem lies in the shortfall of products, particularly of products targeting investors seeking near to market rates of return. The rapid and constant innovation in the sector suggests that this problem is being tackled. As the sector develops, the number of organisations reaching near market level returns will grow. In the meantime, greater use of tiered financing and risk mitigation with these products will help to attract investors in to this sector.

### **7.3 Matching investors' preferences with available vehicles**

This chart identifies a feature of an investment vehicle, such as level of risk protection, and then identifies which investors rated this as highly important. The third column identifies a desirable way of dealing with this feature. The final column matches up a social investment fund which meets this requirement.

**Table 7.3: Matching investors' requirements with current and developing investment vehicles**

Vehicle features	Types of investors rating it as important	Comment / desirable feature	Suitable investment products – either current or under development
Rate of return	► Investment Fund Managers	7%+	Truestone Global Impact Funds International Finance Facility for Immunisation
	► Private Equity	18%+ after 3-5 years	Bridges Venture Fund 1
	► Commercial and private Banks	7% +	Fair Finance
	► Pension fund	Market levels	Bridges Venture Fund 1
Risk perception	► Pension funds	Risk adjusted returns With downside protection	Fixed rate social enterprise pooled funds (suggested)
	► Investment Managers	Seeks protection of downside over high returns	International Finance Facility for Immunisation Revised Social Impact Bond structure
	► Charitable Foundations	Calculate risk but still may accept it for mission development	Social Justice and Human Rights Centre, Ethical Property Co. Allia Bonds, Charity Bank Note, Scope Tiered Bond, Charity bank deposit, Triodos bank deposit, Social Impact Bond International Finance Facility for Immunisation Resonance Social Care Property Fund

Feature of an investment vehicle	Types of investors rating it as important	Comment / desirable feature	Suitable investment products – either current or under development
Level of risk protection	<ul style="list-style-type: none"> <li>▶ Pension funds</li> <li>▶ Investment managers</li> </ul>	Subordinated debt or guarantee or underwriting required to take on high risk	International Finance Facility for Immunisation
Level of Engagement	<ul style="list-style-type: none"> <li>▶ Commercial and private banks engaged in SI</li> <li>▶ Social private equity</li> </ul>	Pro-bono support  In-house expertise  Client mentoring  Board representation	Finance South East & Resonance  Bridges Social Entrepreneurs' Fund, Big Issue Invest Social Enterprise Investment Fund
Fund / investment Type (e.g. OEIC, trusts, open, closed)	<ul style="list-style-type: none"> <li>▶ Pension funds</li> <li>▶ Commercial and private banks engaged in SI</li> <li>▶ SRI investors</li> <li>▶ Commercial banks</li> <li>▶ Charitable Foundations</li> </ul>	Limited Partnerships    OEIC structures Listed shares  Share capital	Bridges Venture Funds 1 & 2, Jacana, Resonance Social Care Property Fund  Big Issue Invest Social Enterprise Investment Fund  Truestone Global Impact Fund,  Big Issue Invest Listed Fund 1 (for development)  Social Stock Exchange, (for development)  listed shares of social purpose businesses and social enterprises
Investment Size	<ul style="list-style-type: none"> <li>▶ Pension funds</li> </ul>	Large minimum size required	Truestone Global Impact Fund



Feature of an investment vehicle	Types of investors rating it as important	Comment / desirable feature	Suitable investment products – either current or under development
		(up to £35m)	Big Issue Invest Fund 1 (for development)
	► SRI investors		Social Stock Exchange facilitated investments (for development)
			Other pooled investment options (suggested)
	► Charitable Foundations		Social Impact Bond
			Resonance Social Care Property Fund
			Finance South East and Resonance
			Impetus fund
			CAF Venturesome Fund
	► (Government budget holders)	Measurable social returns, including savings to public purse	Public sector spin-out opportunities (suggested)
			Health Impact Partners LP
Access to products	► High Net worth Individuals; mass affluent	Via platforms, banks and advisors; build links with IFAs, social business angel networks	Platforms: Ethex, CAF Social Impact, Big Issue Invest Fund 1, Social Stock Exchange, (US Impact Assets) <sup>51</sup> , ClearlySo

This table highlights three key issues:

- 1) there is a shortage of UK social investment products; the same ones, despite efforts to the contrary, are referred to repeatedly<sup>52</sup>. A number of those listed are not yet available, but this table highlights that there are gaps in product provision; social investment opportunities, offering finance first returns are

<sup>51</sup> Refer to 'Impact Assets 50' for further opportunities globally on impact investing

currently mainly in emerging markets, where returns are typically higher (J.P. Morgan, 2010)

- 2) there are far more opportunities to find a fit between products and charitable foundations than there are between products and another other investor type
- 3) this is a very intricate market in which investors have to trade off one priority with another (e.g. risk against return, or social impact against engagement levels) in order to make investments. It is perhaps not surprising that few institutional investors have reached the end of this process and concluded with an investment. Notice the inclusion of government budget holders as potential investors as they too can 'invest' in public service provision.

## **7.4 Products under development, or suggested through interviews**

Interviewees in the course of our research suggested the creation of various types of pooled investment structures to overcome the problems of minimum investment size. The Cabinet Office paper on Social Investment (February 2011) envisages families holding social investments in their pension plans in the long term. We recognise that the social investment market is still a long way from being ready to offer many retail or more widely traded products, but the following are specific suggestions made by interviewees.

### **7.4.1 Social Exchange Traded Fund (ETF): table of core features**

#### **Social Exchange Traded Fund:**

This could potentially appeal to investment fund managers who want to create a social investment tracker fund from exchange listed social ventures. Listing on this ETF could 'badge' companies that meet a set of social criteria. A managing board could be set up to determine criteria and evaluate company listings; it could be established to support companies of a certain size range, e.g. £10-35m, after which point they exit the ETF.

<b>Product</b>	Tracker fund of selected social business shares and bonds, listed on PLUS, AIM and main markets
<b>Asset type</b>	Derivative
<b>Capital raising capacity for organisations</b>	Limited new money for capital raising; fund size can grow over time; marketing initiatives can be staggered to adapt to fund's requirements
<b>Benchmarks</b>	None to date
<b>Supports</b>	Development of social stock exchange; exposure for investors to social purpose businesses
<b>Size</b>	Variable, but could allow for large investments
<b>Range of products</b>	Definition of socially minded businesses will determine the range: if drawn too widely it could weaken the impact focus
<b>Investor interest</b>	Sophisticated investors: potentially high interest for SRI investment managers; easy way of investing in social stock with good levels of liquidity, relative to the sector generally
<b>Restrictions</b>	Would not allow for unlisted products; excludes a large portion of the emerging social enterprise sector

#### 7.4.2 Mission related CIF; table of core features

##### Mission related Common Investment Fund (CIF)

This aims to meet charitable foundations' requirements to invest into vehicles which support their missions. The challenge will be to create a range of mission related investments which are sufficiently trade-able to maintain value, justify high set up costs and meet different charities' missions.

<b>Product</b>	A collection of different mission related investments - listed bonds and listed and unlisted shares, to form a CIF for charitable foundations <sup>53</sup> seeking mission rated investments
<b>Fund type</b>	CIFs are structured like investment Trusts and the fund itself trade as a company
<b>Capital raising capacity for organisations</b>	Yes
<b>Liquidity issue</b>	CIF would expect high liquidity and trade-ability but underlying securities in trust could be hard to trade
<b>Supports</b>	Variety of mission related investments for charitable foundations
<b>Size</b>	Variable, but could allow for large investments; usually minimum investment of £1000 for CIFs
<b>Range of investments</b>	Theme(s) of mission CIF will be important for Foundations; would benefit from international investment options to build size; unlisted bonds are excluded from CIFs

<sup>53</sup> EIRIS (2009) *Responsible Investment by Charities, The Role of Pooled Funds*,

<b>Investor interest</b>	Private client stockbrokers serving charitable foundations have expressed some interest in creating this, but broad mission base could be problematic for specific Foundations; over time, it could sub-divide into themes if sufficient investment propositions are created
<b>Applicability</b>	The same securities could be wrapped up in a variety of different products – products could form a sub-fund of an OEIC and be included in a SIPP in principle: the share components, if listed on main markets it could be presented as a Stock ISA
<b>Fees and charges</b>	VAT exempt for Charities; like most Investment Trusts, need scale of c £45m to make this worth management and set up costs

### 7.4.3 Social Investment Trust plc

This could act as an early ‘tester vehicle’ for the Social Stock Exchange principle but allows for wider range of securities, as unlisted shares and debt can also be included in a trust.

<b>Product</b>	Closed Ended listed Investment Trust
<b>Types of holdings</b>	Shares of public and private companies, debt and cash, listed or unlisted
<b>Capital raising capacity for organisations</b>	Yes, investors purchase a share in the company
<b>Liquidity issue</b>	Yes – trust itself is traded, not the underlying securities; company can trade at a discount or a premium to Net Asset Value
<b>Supports</b>	Various types of capital raising structures for social sector – unlisted shares, listed shares, listed bonds
<b>Size</b>	£200 +
<b>Range of investments</b>	Determined by company, suggest mixture of listed small cap firms with market cap of < £15m and unlisted social businesses, debt and cash
<b>Investor interest</b>	Potentially wide interest; investment banks, other fund managers with micro-cap allocations; retail and individual investors
<b>Restrictions</b>	Trust pays corporation tax but can offset losses against gains; if underlying liquidity is weak, the trust could trade at a considerable discount from its Net Asset Value; <i>all</i> the cash must be raised before fund trades
<b>Fees and charges</b>	Management and transaction fees mean that for funds of under £45m it is not cost effective.

#### 7.4.4 Principle Protection Products as suggested in 7.3.1

##### **Principal Protection Products – generic model for social investment vehicles**

A structured product-to-protect principal was a common requirement of institutional investors interviewed. This was suggested as a way forward for future SIBs (refer to Section 7.3.1).

<b>Product</b>	Could create a pooled fund to provide fixed rate bonds (unlisted)
<b>Length of term</b>	Ideally c 5 years
<b>Product structure</b>	Fund created as an LP
<b>Rate of return</b>	c 5%
<b>Product investment</b>	c 80% invested in cash deposit or equivalent, 20% used for social investment
<b>Range of investments</b>	Could be applied for development of funds to support public sector spin-outs or public sector savings initiatives
<b>Restrictions</b>	Need to raise 5x more capital than is required, takes time, inefficient
<b>Investor attractiveness</b>	High amongst pension funds, investment fund managers, foundations, commercial banks, private banks all sought this protection; investing partners are taxed individually within the limited partnership; tax reliefs attached to it could provide added attraction (see 7.4.6)
<b>Alternative mechanism</b>	Underwrite, guarantee or ring fence budget for repayment of investment through commissioner guarantees or public underwriting
<b>Fees to set up fund</b>	More costly and time consuming to raise and administer multiple amounts; need a 'secure' investment to generate the returns required on the 80% invested

#### 7.4.5 Self Invested Personal Pension Schemes (SIPPS)

The Government would eventually like to see households own social investments within their own personal pension plans (HM Government 2011). A Self Invested Personal Pension Scheme would offer individuals an opportunity to incorporate social and ethical investments into their pension plan. However, there does not yet appear to be sufficient confidence in the social sector market to secure a product provider, administrator and promoter required to generate social investments in a SIPPS. Unlisted bonds (regularly used by the social sector) are currently excluded from most SIPPSs and some providers exclude unlisted shares. Hypothetically, the product would contain the following features:

<b>Product</b>	Self Invested Pension Plan
<b>Scheme requirements</b>	Administrator, scheme provider and fund manager
<b>Allowable investments</b>	Listed and unlisted shares (with certain restrictions); listed bonds and loans, deposits, commercial property, OEICs and other CIFs, Investment trusts
<b>Tax relief</b>	20% added to pension contribution; funds free of income tax; free of Capital Gains Tax
<b>Investors</b>	Individuals
<b>Sales route</b>	Via intermediary e.g. product distributor or a platform
<b>Restrictions / challenges</b>	Reputational risk of a distributor willing yet to market such a product; Administrator approval required
<b>Costs</b>	Must be authorised by the FSA – expensive

#### 7.4.6 Social Venture Capital Trust Plc

Although this is not a vehicle targeted directly at the institutional investor, private wealth managers see such a tax scheme as a potential way of engaging high net worth social investors. The investment is locked for 5 years and the investees in the trust must comply with tight restrictions on size and type of activity.

<b>Form of investment</b>	Ordinary shares, listed on a UK stock exchange
<b>Form of further investment by the first recipient of the funds (the investee)</b>	Equity, loans and securities in small companies not listed on a recognised stock exchange, but AIM or OFEX, PLUS listed companies also qualify
<b>Legal form and accreditation of the investee</b>	VCTs are a form of investment trust but legally they trade as listed companies. Must be pre-approved as VCT by HMRC
<b>Qualifying investor</b>	Tax reliefs are only available to individuals aged 18 years or over and <b>not</b> to trustees, institutional investors, companies or others who invest in VCTs
<b>Lock-in period for tax relief</b>	5 years minimum holding period
<b>Limit on investment</b>	£200,000 in a tax year
<b>Details of tax relief</b>	<ol style="list-style-type: none"> <li>1. For purchase of new shares issued by the VCT; 30% of the subscribed amount deducted from tax payable for the year, or the tax payable, whichever is less</li> <li>2. No income tax on dividend income received</li> <li>3. No capital tax gains on disposal of the shares provided the shares have been held for five years</li> </ol>
<b>Additional investor return (from the investment itself)</b>	Possible. Depending on the performance of the underlying portfolio of investments, the VCT may distribute income in the form of dividends, on which investors are not liable for tax

<b>Restrictions/conditions on deployment of funds</b>	1. Restrictions on business activities carried out by the investee company
	2. At least 70% of the VCT investments must be in new 'qualifying investments' e.g. shares in private UK companies which carry on qualifying trades and this level must be reached within three years
	3. Of this 70%, currently 70% must be in qualifying equities rather than loans
	4. Maximum size of company VCT can invest in is £15m gross assets with <250 employees (as of 6 April 2012)
	5. Limit of £1m per rolling 12 months from a single tax-favoured vehicle, but the company can receive £10m in any tax year and the holding cannot be > 15% of total holdings at cost
	6. VCTs cannot retain >15% of income derived from equities/securities
	7. Minimum 10% equity component of each qualifying holding
	8. Investee company cannot be controlled by VCT or another company
<b>Taxation of income of the recipient of the funds (investee)</b>	Exempt from corporation tax and capital gains tax
<b>Investor interest</b>	Individual investors, particularly HNWIs wanting to offset Capital Gains and not reliant on income

Source: adapted from (Heaney, 2010)

Issues around creating a Social Venture Capital Trust are:

- There must be at least 10% equity holding, either listed or private equity
- The funds must be deployed in a given timeframe
- Costs for a small fund are disproportionately large
- Target investors have to be eligible to benefit from the tax relief (retail investors) but not applicable for institutional investors
- VCT has to pay its investors predominantly from capital gains – exit can be difficult for social enterprises
- There must be no controlling shareholder in the investee companies – this can be problematic for certain types of investees

This structure has not yet been adapted for social investment.

#### 7.4.7 NESTA<sup>54</sup>: 4 vehicles/ products for development

The social intermediary market is full of innovation, as demonstrated by the range of new products suggested for development by NESTA's Public Services Laboratory. Four of these will be funded for further development as part of the Big Society Bank's remit. The new products take various forms and demonstrate the range of need for financing from start-up level to providing finance for larger-scale social enterprise and charitable organisations.

**The four selected vehicles for further development include:**

- Investing for Good charitable note programme – providing loans to household named charities
- Fair Finance – building on successful commercial banks' investment to take personal lending CDFI to a sustainable scale (see case study below)
- Finance South East and Resonance – angel investment support for social enterprise
- Impact Assets – research support to consider extending the US Impacts Assets platform across Europe.

Details of a selection of existing and developing investment products are given in the Annex at the back of this report. Each one targets different types of investors and offers a wide range of investment products, which the market needs to build up diversity.

Fair Finance has already engaged commercial banks in its growth and the case study below demonstrates the important role of cornerstone investors to lever in further capital. The Big Society Bank, in its role as a potential cornerstone investor, could catalyse more such investment opportunities.

#### Case study



#### **Fair Finance, the cornerstone investors and the engagement of commercial banks**

*'We've taken something that doesn't sit in the mainstream and shown how it can work.'*

Fair Finance is a microfinance organisation that aims to reduce financial exclusion by reinventing personal finance to make it more inclusive. It provides access to bank accounts, personal finance, business finance and debt counselling to communities in London. It has proved the business case for its lending services and in order to scale them it required: loan capital to grow its loan book and investment capital to cover its core expansion costs.

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<sup>54</sup>National Endowment for Science Technology and the Arts



By separating out these financing needs, it approached different funders for different requirements. It raised **£2m in debt finance from Santander**, Société Générale and BNP Paribas to use for on-lending. A further £350k was secured from the NESTA Big Society Finance Fund to help speed the growth and ensure leverage ratios were maintained. This finance was raised on commercial terms which will ensure that it can scale upwards as the business grows and is successful. However a key part of the banks' support was ensuring that the investment capital for expansion had been already secured. Up to £750,000 had been secured by angel impact investors such as Venturesome, Ashoka and various HNWLs which provided comfort and underpinned the banks' capital.

Faisal Rahman, CEO of Fair Finance said

“By separating our social investment needs out we've been able to leverage it against the commercial debt financiers to scale up to 5 times more than we could have otherwise have raised. This is a more efficient use of the various financial tools available to us and will ensure that we have enough finance and capital to achieve sustainability.”

“In this model each investor participates at the appropriate point in the capital structure consistent with their risk profile” says Mark Cheng of Chelwood Capital who advised Fair Finance.

Fair Finance will open up to eight more offices in London over the next four years, and expand to help nearly 100,000 people. It believes its business model is scale-able and could be replicated by other Community Finance organisation and social enterprises which struggle to cover their overhead costs

## 7.4.8 Building the market place

Here we look at certain social investment 'enablers' that help to develop the market infrastructure for social investment.

### 7.4.8.1 Social Stock Exchange (SSE) and other platforms

Investors aim to balance their need to provide longer term patient capital to social enterprises with their desire to sell an investment which they perceive as weak. Liquidity in social investments is hampered by the sector's frequent use of unlisted assets (predominantly bonds but also sometimes shares), which are cheaper ways of raising finance. Unlisted investments have no natural price-marking mechanism and it can be hard to create a viable market for them. The trading platforms under development tackle different difficulties in access to social investment and in time, aim to increase liquidity within the market.

Investors were generally positive about the development of the Social Stock Exchange (SSE) and other platforms as having a potential role to play in building up liquidity in the

market place over time. They recognised that the SSE is currently 'ahead of its time', but that it was an important part of the infrastructure to allow for future institutional and retail investment flows. By trading shares in social companies with a market cap value of £10m+, this will eliminate early high risk start-ups, which will be offered on other platforms (see following). By providing a Recognised Investment Exchange, the SSE opens up the market to a wider variety of institutional investors. It would provide daily price discovery, entry and exit routes for traders in to social investment marketplace and a platform to launch investment schemes. The Social Stock Exchange's appeal as an investment vehicle will in part depend on the extent to which targeted social businesses seek to raise capital in this way, given the associated costs. Details of the SSE are listed in the Annex.

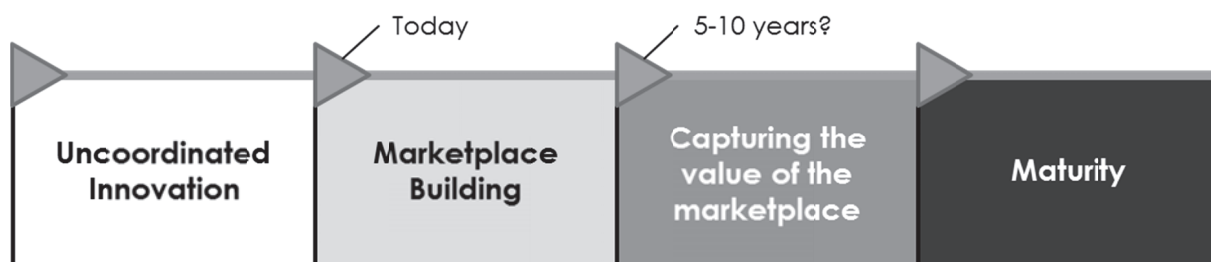
The Ethex platform seeks to provide a 'crowd investment' platform for smaller companies to offer co-operative shares, cash deposits, social bonds and company shares to investors. The aim is to democratise the finance system, reduce transaction costs by eliminating intermediaries, improve liquidity through creation of a secondary market and widen accessibility to a range of new ethical investors. It sets out to assist ethical businesses in attracting much needed patient share capital. There is a natural continuum between Ethex and the Social Stock Exchange. As these ethical businesses grow, they may list on the Social Stock Exchange. Both these platforms are at development phase of currently seeking investment. Details of the investment propositions are given in the Annex.

The investment re-financing platform SharedImpact, which is currently under development, aims to act as an intermediary between retail investors, other finance providers and the charity or investment fund seeking support. By aggregating small investments and donations, re-financing of existing loans to charities can be made effectively and cheaply.

Infrastructure developments, such as these, could pave the way for the eventual entry to the retail product market. Eventually, social investment products can be wrapped in vehicles such as SIPPS and social Individual Savings Accounts (ISAs).

It is important to ensure that there is integration in the social investment market place, and there is complementarity between the different platforms and investment mechanisms as they develop. Chart 7.4.8.1, adapted from the Monitor report on impact investing, maps out the stages of market building:

**Chart 7.4.8.1: Stages of infrastructure development**



Adapted from Investing for Social and Environmental Impact; Monitor Institute, 2009

## **7.5 Key recommendations on products**

The social investment market is struggling with the combination of a shortage of investable propositions and a lack of choice in the product market. The Social Impact Bond and the Bridges Ventures 'finance first' funds are products which could offer returns of a level that would meet institutional expectations. Otherwise, the products currently available are targeted at 'impact first' investors, such as HNWIs, venture philanthropists, Corporate Social Responsibility managers and charitable foundations. The products appear well-tailored and successful at raising money from these target investors, but this leaves a gap in the market. Ethical shares have, to varying degrees, offered blended returns and this appears to be an area for growth as share capital increases within the sector. Quasi-equity investment opportunities are just beginning to be used, so we need more time to establish how well these meet the needs of both investors and investees. Bespoke social bonds yielding blended returns are not widely available to institutional investors or for trading, but this could change if the investor pool widens. We uncovered little evidence of underwriting UK social investment products but some use of 'tiered' financing (donations and loans in one product) in the Allia and Scope bonds.

As discussed, there are many new products in development stage, as evidenced by the range of products listed in the Annex. In fact, one challenge will be to keep the social enterprise development in pace with the product development. The increasing attention on developing the infrastructure to support social investment will extend the access to products for individual, and in time, for institutional investors. Although there is only so much that the investment vehicle can do to make a proposition attractive, there is much that could be done to make it easier for interested investor to engage in an attractive proposition.

We see the Big Society Bank as perfectly placed to work with partners to take forward much of the intricate work in developing the product market. This is discussed further in Chapter 9.

### Key recommendations on products

1. Ensure product design and investment opportunities keep pace with each other
2. Tackle the need for mitigation of risk in product design; this means underwriting or guaranteeing certain investments to generate investor security while products reach higher rates of return
3. Know the target investor and create the product to appeal to that type of investor; many products are required for range of investor types
4. Continue to experiment with social impact measurement tools in order to give investors confidence in the blended returns
5. Build up the infrastructure in an integrated fashion to give access to investment opportunities; this is as critical as the products themselves
6. Look widely for investor partnerships; innovation is key in this sector

**Key point: tailored products for tailored markets: no one size fits all**

## 8 Financing Social Enterprises and Spin-outs as Public Service Providers

### 8.1 Present position, policy context

There are two parallel but related strands of government policy around social enterprises' ability to deliver services to the public sector.

Firstly, the Government is keen to see the 'power shift' to local communities. It has long term aims for 1 million employees to form 'social enterprises, mutuals, cooperatives and charities' – referred to as 'civil society organisations<sup>55</sup>' - to take up the challenge and deliver public services on a contract basis. This process began under the previous Labour Government, beginning with Health and Social Care sector. A range of health and social care 'spin-out' organisations have recently launched and more are due imminently.

Secondly, there is the role that existing social enterprises have had and aim to hold on to in providing services to the state under public service contracts. These organisations are affected by two issues: the budgetary cuts and the public service commissioning terms.

Both of these groups of public service providers have potential demand for capital finance, although the type, time and form vary from one organisation to another.

The recent outsourcing of social and public services has far reaching consequences for the social enterprise sector. 39% of social enterprises receive half of their income from contracts with statutory bodies (Social Enterprise Coalition, 2009). Civil society organisations had an income of £9.1bn from state contracts in 2007/2008 (Government Commissioning Green Paper, 2010). Spin-outs currently account for around £0.5bn of government contracts but tend to be larger in size than average social enterprises.

This 'power shift' to civil society organisations potentially creates new and interesting larger scale dynamic social enterprise investment opportunities. But the case needs to be made to attract investors to support their ambitions. One investor interviewed in this research identified that the opportunity to invest in outsourced public service provision is complicated by:

*'the need to convert the public service delivery system from an input based to an outcomes based process'.* (Investment fund manager)

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<sup>55</sup> 'many mutuals and co-operatives are profit-making businesses, which operate for primarily commercial objectives. However, they are included in this definition owing to their role in public service provision' (Government Commissioning Green Paper, Dec 2010).

This process is capital intensive and requires large scale human and financial resource planning. Any such period of substantial change to payment and delivery of public services is a volatile time to engage private investors.

## **8.2 The challenges posed to identifying good investment propositions**

The challenges faced to attract private investment into public sector spin-outs are also relevant to existing social enterprises seeking to win contracts for public services. Our interviews suggest that:

- Investors would seek a return on their investment commensurate with the perceived level of risk, or see their risk mitigated. Although spin-outs have a track record within public sector, the requirements of running an enterprise raise the risk level
- Lack of clear public service delivery data means it is difficult to establish where the best investment propositions lie
- There is a lack of clarity over the processes to determine which services are likely to be offered up for commissioning, over what time period and on what contract
- Payment by results poses a potentially risky proposition for private investors
- Where contracts are managed by many agencies at local level, investors would seek high level of co-ordination from budget holders to feel confident in an investment proposition
- Investments in to social enterprise structures with an asset lock loses some liquidity which can be less attractive to an investor (the government encourages use of these structures to ensure public benefit)
- Investors are less willing to finance spin-out organisations that have to enter an initial competitive procurement process, or where there is no guaranteed contract; lack of contract security is also a problem for existing social enterprises seeking finance
- Budgetary changes could dramatically affect the viability of a business model and therefore the investment proposition e.g. 'pooled budgets' for health and social care of those with complex needs and the introduction of a Universal Credit System, (still at embryonic stage), could all directly affect the revenue streams of service providers and therefore investors' willingness to invest in these service providers
- Commissioners' move towards contracting with larger scale organisations means that many social enterprises are too small to compete; they do therefore have a role to play in sub-contracting, but their special impact generating features are potentially distanced from the contract process.

The specific timing needs for investment, pre spin-out, expansion finance are discussed next.

## **8.3 Health and social care sector spin-outs leading the way**

Health and social care spin-outs have had three advantages which might not apply to other sectors as they spin out:-

- This sector has had support from the Social Enterprise Investment Fund, a budget of £100m in total (with a minimum budget of £10m allocated for 2011/12<sup>56</sup>). Other sectors are unlikely to receive this type of support given the budgetary cuts in place
- the health sector budgets, whilst they have been re-configured, have not gone through the same degree of reduction as other sectors are facing
- the health sector spin-outs are generally larger in size than may be the case in other sectors, which is likely to help in meeting the size threshold for contract size that is due to apply.

There have already been a large number of spin-outs, with revenues ranging from sizes of £0.5m up to £60.0m+. From an investor perspective, these organisations could provide the missing scale that the social enterprise sector has lacked in general. The investment cycles, and its challenges, are discussed below.

#### **8.4 Investment cycle for spin-outs and public service providers**

The investment cycle of spin-outs requires different forms of financial support at each of the five stages of the process: from options appraisal (Stage 1), business planning / tendering (stage 2), set – up or transition (e.g. TUPE<sup>57</sup>) (stage 3), launch (stage 4) through to the operational phase (stage 5). Not all spin-outs seek financing in order to set up their enterprise, if they are well supported from their ‘parent’ authority and have secure contracts in place.

Each stage requires different forms of capital and only those supported or which are robust throughout the funding cycle will reach Stage 5. There is a clear need for tiered financing to meet these requirements, such as grant financing up to stage 2 or 3, with support for legal and staff transfer costs at Stage 3. Stages 4 and 5 will require a combination of working capital and risk capital. There is also the likely need for expansion finance in approximately 3 -5 years after spin-out.

#### **8.5 Potential sources of capital**

So where might the capital come from once all government financing runs out? On the private investor side, in spite of the fact that these spin-outs have the potential to generate scale and impact, our research uncovered an interest in the opportunities offered by spin-outs but a limited appetite to develop investment vehicles to support such organisations (for reasons discussed in 8.2.)

One fund manager and one consultant suggested that a venture capital fund be developed, bringing together governmental or institutional money alongside private investment. It should have monitoring and support integrated into the fund as part of its

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<sup>56</sup>The SEIF is currently working together with the Department of Health to finalise details of what kinds of financial products and support will be available in 2011/2012

<sup>57</sup>Transfer of Undertakings Protection of Employment

costs, available for all investees in order to ensure that spin-out organisations 'did not fall at the first hurdle'. In terms of actual funds ready to support this sector, ClearlySo only uncovered one private fund that has recently launched to support medical support staff spinning out of the NHS. The fund, Health Impact Partners, LP, will invest in spin-outs and other social enterprises that provide value or savings to the NHS. These may be created through improved services in the fields of end of life care, tele-health care provision or reductions in emergency admissions. (Details of this fund are in the Annex).

Social financial intermediaries are interested and actively pursuing ways to fill this need. CAF Venturesome already provides underwritten loans to social enterprise and charities. It offers working and transitional capital or bridging loans to cover cash-flow difficulties as might be caused by the 'payment by results' arrangement or the need to generate new revenue streams. Big Issue Invest has been considering development of a Special Purpose Vehicle that would raise investment for on-lending from banks to spin-outs. But this needs development finance. Other social intermediaries are looking at the establishment of tax efficient funds such as social Venture Capital Trusts as discussed in Chapter 7. Local Partnerships developed a fund in concept to support spin-outs which focused on the area of youth services as a primary service area.

ClearlySo's research found that investors appreciated the business model of Social Impact Bonds in which public sector savings paid for the return to investors. It is likely there are many more opportunities for savings from the public purse to be used as the basis of a range of investment packages as the reform of public services is rolled out. Public policy recommendations to tackle the range of issues addressed are given below.

## **8.6 Key public policy recommendations**

Investors are likely to be more attracted to invest in social enterprise service providers and spin-outs if the following considerations are taken into account:

### **Evidence base**

Government and service providers need to provide a substantial base of evidence to establish the business cases for investment in public service provision. Without this, it is difficult to build up understanding of the most appropriate business models for service delivery and thus persuade investors of the economic viability of investing. Further analysis and evidence of impact of supply of funds on quality of investment requests, analysis of different use of assets, integration of grants with loans, and other aspects of the government investment programmes would help to inform future investment product design.

### **Clarity on opportunities for civil society organisations**

The government needs to provide clarity about what procedures at local and central government levels are in place to guide the process of opening up of services, without controlling the process from the centre; there needs to be clarity on the potential for



creative use of budgets and reassurances about payment processes to provide investors and enterprises with the necessary reassurances of cash flow.

### **Pooling local authority commissioners as budget holders**

The delayed Government White paper on Open Public Services will help to establish the room for social enterprises to be given consistent consideration for their social impact in commissioning. There is also a key role for government to assist collaboration amongst different local government budget holders to identify where savings can be made across departmental functions as a basis for offering contracts<sup>58</sup>. By encouraging local authorities to play more of a role as potential guarantors of initiatives, the investment opportunities open up.

### **Clarity on guaranteed contracts and procurement processes**

For investors to provide finance to spin-outs, they will seek clarity on contract guarantees. This would be determined by whether there would be an initial competitive procurement process, and / or whether there are guaranteed or secured contracts over fixed time periods.

### **Defining and supporting the players in the sector**

There is a need to ensure that the public benefit mandate is protected to all civil society groups with which the government seeks to engage in the spin-out process. The commitment to social enterprises as service delivers needs to be fed through into all the necessary stages of spinning out from providing support for pensions, TUPE<sup>59</sup> arrangements, and legal support as well as for secure, clear commissioning and contractual procedures.

### **Positioning social enterprise in government**

The voice of social enterprises needs to be heard clearly both in government and in the investment community. Whilst the 'enterprise' aspect of social enterprise originates from the Department for Business Innovation and Skills, the 'social' dimension is clearly housed in the Office of Civil Society. This dual facing profile in government can allow it to play critical roles in both social and economic dimensions. Social Enterprise Ambassadors and representatives of the sector, both as entrepreneurs and financiers, could be proactive in pursuing these profiles within government.

### **Use of tax regimes in social investment to:**

- Incentivise investors as well as donors (who use Gift Aid) to support local service provision delivered through charities and social enterprises
- Provide tax relief for investments lost to social enterprises; repeat the call for tax breaks to Community Interest Companies; provide tax incentives for entrepreneurs to move into social enterprise

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<sup>58</sup>Recent research from PWC shows that local authority policies and practices over procurement are reported as being relatively weak and need strengthening significantly (Price Waterhouse Coopers, June 2011).

<sup>59</sup>Transfer of Undertakings Protection of Employment

- Reduce restrictions on sectors eligible for tax relief e.g. under Enterprise Investment Scheme and Venture Capital Trust to be able to include nursing and residential care homes
- Extend the use of the Enterprise Finance Guarantee Scheme, to cover Community Investment Tax Relief loan made by Community Development Finance Institutions to social enterprises operating in areas of deprivation (Heaney, V., 2010).

ClearlySo, along with most social financiers interviewed, anticipates that there will be a process of experimentation of business models and investment products to meet these needs. It is difficult to predict whether this will lead in the long term to proliferated consumer choice and full service coverage or instead to a higher degree of concentration of service providers with reduced public choice. Certainly, much will depend on the capital investment being available at different stages in the business cycle. Its shortage could threaten the 'power shift' talked of in the Green Paper on Commissioning, to civil society organisations as deliverers of public services. This could limit competition in the long run.

This highlights the urgency of the need to provide finance. If the BSB, informed financiers, policy and sector experts collaborate closely with institutional investors, they could bring about the support the social enterprise sector is likely to need at this pivotal time.

## 9 Role of the Big Society Bank – What Will it Do, What Could it Do?

### 9.1 Outline business plan – BSB remit

The innovative but small social finance and intermediary sector needs a champion if it is to develop. The Big Society Bank aims to be just that. To be funded from a combination of £400m of unclaimed assets, to be injected over the next four/five years and £200m of commercial bank finance from the “Project Merlin” agreement, the BSB is unique in the world in its proposed role of supporting social investment and helping to build the marketplace for it. It has still to receive full EU state aid exemptions and FSA authorisation. Until that point (expected in the first half of 2012), the Big Lottery Fund will become responsible for dispersals of capital (£5 million has so far been allocated). BSB will not issue grants, nor will it lend directly to individual social enterprises, but will provide capital to intermediaries for onward investment - it will be an entirely wholesale institution. It aims to be self-sustaining financially in the long term, although not profit-maximising, given its market-building mission. The BSB would, in time, cover its operating costs and any asset impairment from the return on its investments. Its own financial modelling suggests that ‘this self-sufficiency could be achieved after an initial period of five years or so during which there would be some attrition of the BSB’s capital’ (BSB Outline Business Plan, 2011).

The success of its efforts will be judged by its impact on the social investment market to grow sustainably and by the social impact of the investments which the Bank makes, ‘where this can be determined directly<sup>60</sup>’. The BSB will have sector based teams to reflect its priority areas and will act as a champion to lever in institutional investors.

NESTA stresses the BSB’s role is “creating leverage” saying that because its activities in accelerating the emergence of the social investment market will be costly, it is likely to have difficulty in delivering ‘market rate’ or commercial levels of return.

*“therefore ‘a development bank’ is needed to focus on developing the infrastructure of the emerging social investment market, catalysing the intermediaries to raise capital from a breadth of investors - commercial institutions, charitable foundations and individuals and thus allowing them to develop a greater degree of sustainability whilst meeting the needs of social ventures.” (Ludlow, J., NESTA, 2011)*

#### What will it do?

BSB’s outline Business Plan was released in May 2011. The bank is likely to play a role as:

- an independent champion to communicate with and leverage capital from other managers of capital
- a wholesale provider of patient capital and of limited subordinated debt
- a potential provider of support for public sector spin-outs’ need for capital
- a partner with foundations, government and institutions to lever and structure finance
- a potential role as honest broker for the sector with government over sector policy

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<sup>60</sup>Growing the Social investment Market, H M Government Feb 2011

- a support for new product development that investors and investees need.

Good governance will require it to:

- balance use of capital now as against use in five, ten and twenty years' time
- balance returns between the present and the future, where its success will be more evident
- manage expectations for its financial sustainability if it is to be truly catalytic
- inject resources into intermediaries for their own discretionary use and measure that benefit
- clarify investment terms, running costs and ownership structure, which could influence its possible activities
- help the marketplace to develop a methodology for impact measurement which could set sector standards
- be totally independent in its relationship with Government
- be transparent in its establishment of its organisational structure: details of its Board and further details on its structure are due out imminently.

The bank will have expenditure functions which are broadly divided into infrastructure development and on-lending costs. More specifically, they are identified as:

- Co-investment of equity or debt in social-purpose funds managed by intermediaries
- Provision of subordinated capital to social investment intermediaries and funds
- Investment in existing intermediaries
- Investment in infrastructure organisations
- Investment and underwriting for innovative financial products
- Information sharing and networking, research and capacity building activities

## 9.2 Implication of outstanding points of clarity

### Project Merlin Funding Terms

The terms of the commercial investment under Project Merlin and the ownership structure of the commercial banks' engagement are not yet clarified or made public. The final arrangement is critical because the BSB is structured such that unclaimed assets are likely to be subordinate to commercial banks' finances should the BSB become liquidated. Also, a provision in the draft Merlin agreement mentions that the banks' funding will be "on commercial terms". However, we understand that the banks are committed to the aims of the BSB and to "*achieve returns against a double bottom line of social and financial impact*". The exact terms of this investment have yet to be finalised<sup>61</sup>.

There is a risk that the tail could wag the dog as the terms of the Merlin banks' investment will influence how the BSB divides its funds across investments with higher or lower financial returns. The "Project Merlin" discussions around terms of the banks' engagement are on-going at the time of writing.

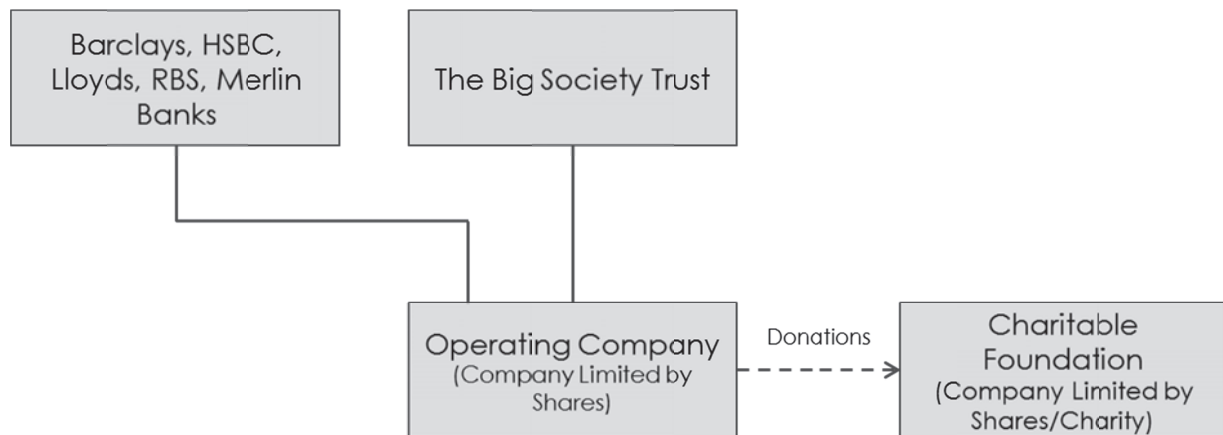
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<sup>61</sup> House of Commons written answer, 8<sup>th</sup> June 2011, from Hansard <http://services.parliament.uk/hansard/Commons/bydate/20110608/writtenanswers/part017.html>

The BSB also needs to strike a delicate balance between the need for catalytic finance now against the need long term growth finance, and to match its likely low levels of liquidity against its financial sustainability. According to many, the Bank's unique feature is 'less about the interest rates and more about the patient capital it could bring to the market' (Jenkins, 2011, Social Enterprise Live).

### **Governance structure to be clarified**

The organogram below provides details of the agreed structures.



The Big Society Trust, a company limited by guarantee, is the holding company and responsible in particular for safeguarding the social mission of the BSB with specific powers in this regard. There are two routes through which finance will reach the BSB's operating company, a company limited by shares. The unclaimed assets funds will be directed by government once State Aid approvals are received into the BSB. It is not yet clear in what form the investment from the four commercial banks will be channelled into the operating company. Clarification over the exact structure of the commercial banks' involvement could allay nervousness to private investors looking to co-finance projects with the BSB.

### **Onward wholesale investment**

The BSB will make investment capital available to social finance intermediaries who seemingly may be themselves either non-profit or for profit organisations. Those intermediaries who receive BSB funding must use this capital in support of civil society organisations (third sector organisations as defined in the legislation). Presumably the BSB will need to put in place appropriate processes to track the finance it is making available to intermediaries and to help those intermediaries determine the scope of eligible onward investees. It will also need to agree appropriate reporting of investment performance.

### 9.3 BSB role fits with sector's needs

However, the remit of the BSB fits very well with the needs identified by investors and product developers in this research. The BSB should do all that it aims to do in its Business Plan, according to those we met in conducting this research. It sets out to tackle the key barriers to catalysing the market. These areas of activity are listed below and mirror many of the issues raised throughout this report.

#### 9.3.1 Information on social investment

We see many information needs emerging through the course of this research. These can be broadly categorised into educating investors, advisors and support agencies. There is the need to develop a concerted information and advice programme for trustees of foundations on the scope for MCI within their fiduciary duties (and for pension funds in the future). The wealth managers of private clients and foundations will need to be helped to get up to speed with the developments of products available to offer their clients. The BSB is perfectly positioned to keep the FSA and other financial support agencies informed on social impact investing. We also recommend it liaises closely and, in future, collaborates with the Association of Independent Financial Advisors and Institute of Financial Consultants to promote and take to market the initiatives of the social enterprise sector via their members.

#### 9.3.2 Underwriting / guarantee provision

The BSB Business Plan states that to the extent that BSB insures against first loss or takes underwriting risk, these exposures will be 'limited to a small proportion of its assets' (Big Society Bank Outline Business Plan, 2011).

Interviewees saw this remit of the BSB as critical to attracting other investors into social investment. Our research shows the limited appetite for risk at this early stage of the sector's development and how such facilities would help to tackle this. The BSB will be likely to aim to work in co-financing partnerships, where this key underwriting role can be shared as well. It may have problems leveraging in significant institutional funds without exercising this possibility. The BSB faces similar issues to those of the Green Investment Bank around underwriting of loans. Philip Jones, investment manager at the London Pension Fund Authority, said:

*"The Green Investment Bank should be a green investment insurance operation. Unless you can insure projects, a lot of them are going to wither on the vine."*

*(Guardian, 23<sup>rd</sup> March, 2011)*

This reflects the overwhelming investors' perspective in risky early-stage impact investing and is certainly applicable in the case of social investment where the returns are perceived to be at least as uncertain as in the green sector. However, investors looking for guarantees will appreciate the BSB's need to balance the calls to shoulder a degree of private investors' risk in order to catalyse the market with the need to generate its own longer term financial sustainability to ensure it is still engaged in the social investment market place in the long term.

### **Cornerstone investor**

By acting as cornerstone or capstone investor, the BSB will provide long term patient capital in equity or quasi-equity form and could catalyse substantial sums of private capital. In this way, it aims to attract institutional investment over time to its Big Society agenda. Models of its allocations are to be based *'on a balance between social investments which are likely to yield positive returns and social investments where returns are likely to be uncertain'* (BSB Outline Plan, 2011). Again, its capacity to take on this role will be influenced by the terms of the Merlin Banks' financing terms and reiterates the importance of the need to secure terms in line with the BSB's critical mission – to catalyse the sector.

### **9.3.3 Social metrics development and research**

The BSB outline plan also refers to the remit to communicate research on social impact measurement. This has already been discussed in Section 5 and 7. However, there will be considerable attention paid to the social impact methodology that the BSB itself adopts in its lending to social intermediaries. There is much that could be learned through best practice, taking examples from other countries and sectors. The BSB Outline Business plan suggests it will play a key role in this.

### **9.3.4 Support for public sector spin outs**

In the absence of other obvious funders, the BSB is likely to be heavily called on for provision of, or galvanising of, capital for forthcoming spin-outs, especially given that government funds are likely to have been exhausted by the time that non-health sector spin-outs are looking for capital. For this, it needs to champion the economic viability of socially structured spin-outs to private investors. It may need to act as independent broker between investors and government to ensure that the move to include social enterprises as providers of public services does not falter from capital shortages.

### **9.3.5 Development of infrastructure, products and support for intermediaries**

Usefully, BSB will *'spur the development of the market infrastructure necessary to boost social entrepreneurship by supporting the growth of existing and new intermediaries'* (BSB Outline Business Plan). The provision of wholesale funds limits any risk of crowding out the existing players in the market. But it is also likely to offer capital of a wholly different nature to that which is currently available more widely: it will hold *'an investment portfolio which will comprise uncertain returns with poor liquidity'* (BSB Outline Business Plan). This could be particularly catalytic.

As outlined in Chapter 7, NESTA and Panahpur have funded development work from a BSB Finance Fund to develop four catalytic investment vehicles, designed to appeal to a range of different investors and fill various capital gaps in the market. Some of these investment products are 'enablers' in that they seek to provide improved access to social investment; others are capital raising vehicles in themselves. This refers to the need to develop the infrastructure alongside the products to widen the field of engaged investors.

A recent NESTA report (Joy, I., 2011) also highlighted the need for funds to enable the social investment intermediaries themselves to develop their own enterprises. This is a critical role for the BSB – not just to finance their needs, but also to support them, with common approaches, leading work on social measurement metrics, analysing the sector's financial performance and helping to bring co-ordination to the range of initiatives underway and avoid wasteful duplication without disrupting competition overall.

### **9.3.6 Champion for the sector / PR for new initiatives and opportunities**

Currently, there is no coordinating voice with over-arching legitimacy for the social finance sector and the messages sent out can be confusing and anecdotal. This is a highly innovative sector which announces new initiatives regularly. We also saw clearly in the course of this research, that those products that had been well marketed had a head start in engaging with the investor. Again, we see BSB as having a prominent role to promote the new developments and achievements of the sector to the wider audience.

### **9.3.7 Policy liaison role with Government**

We recommend that BSB supports the sector's requirements for public sector commissioning clarity, secured contract arrangements, finance capacity and in the payment structures introduced for such contracts, to support the social sector's continued role in providing services on behalf of the state. We would also see its role to be involved in discussions with H M Treasury on fiscal proposals, together with and alongside other intermediaries, but also as a voice for the sector.

### **Conclusions: role of Big Society Bank in accelerating social investment**

On informing the Public Administration Committee of further delays for the launch of the Big Society Bank until 2012, Sir Ronald told the MPs, "*Don't expect a revolution,*" warning it could take "10 or 20 years" to see real achievements from the bank. This re-iterates the extent to which this is a long process of gradual organic growth balancing financial with social returns, now and in the future.

However, ClearlySo and interviewees participating in this research broadly see the BSB's arrival as timely and a potential game-changer for the sector. Its remit is wide, highly complex and requires detailed work in many specific areas. A number of the key recommendations arising from this research fall within the scope of the outline business plan of the BSB. We see the need to be patient for results, as the BSB draws up a long list of small effective things to do, working alongside the many innovators, fund managers, intermediaries and entrepreneurs in the sector to take the agenda forward.



## 10 Specific Recommendations

### 10.1 Summary: Aim of recommendations; key areas for action

As already stated, we see that the report's findings suggest that there are a large number of small tasks that need to be done to accelerate social investment amongst the institutional investors. These tasks broadly fall to the BSB, Treasury, government departments, Social Financial Intermediaries and other supporting agencies in the short term. But all avenues need to be kept open, to collaborate with the institutional investors to generate new ways of meeting social enterprises' ambitions with society's growing needs.

### 10.2 Long list of small things

Below we draw up a check list of tasks to do which we feel will help to catalyse the social investment market.

#### 10.2.1 Advice, information and skills requirements

Recommendation	Suggested possible contributors	Reference In report
Develop a comprehensive information programme tailored to suit the following key audiences: investors, IFAs, financial consultants, private wealth client managers, stockbrokers	Financial services training agencies and organisations, charity accountancy firms, Charity Commission	4.1 4.3.4 4.8.4 9.3.1
Provide knowledge and advice to social entrepreneurs on how to identify financing opportunities which are attractive or suitable to impact investors	Business Link, social business consultancies; UnLtd, mentoring services	4.7.4
Help social entrepreneurs design and present investment packages that suit the target investors' needs	SFIs, advisory services, social enterprise consultancy firms, UnLtd, ClearlySo, other social financial intermediaries	4.7.4
Provide information and advice to Board trustees of foundations on how fiduciary duties fit with social investing	Charity accountancy firms, Charity Commission	4.5.4
Discuss with SIPPS providers whether social investment can be applied to	Financial product designers	4.8.4

retail products, given its perceived high risk		7.4.4
Communicate with private investors on social impact investing, opportunities and how to access the products	BSB and providers of infrastructure, platforms, social financial intermediaries	9.3.1
Work with SRI consultants and fund managers to link client groups of SRI and social investment; work jointly on product design	SRI experts, social product designers	4.2.3
Build links with business angel networks to link potential investors with investees	SFIs e.g. ClearlySo, private banks, other business angel networks, foundations	4.7.4

## 10.2.2 Social metrics development

Recommendation	Suggested possible contributors	Reference In report
Develop fuller understanding of investors' requirements in social impact measurement; hold forums to discuss this with interested investors	BSB: SFIs, SRI investors Other known interested commercial investors SROI network, other social impact measurement networks Think tanks	4.1 4.6.4
Improve link with social impact measurement and use of these in ESG; work with mainstream businesses seeking to provide ESG measurements	Enterprises, Social financial intermediaries Think tanks, trade associations SRI networks	4.3.4
Start to develop a rigorous consistent mechanism for measuring impact, which might eventually lead to more standardised metrics; pilot new measurement techniques, re-iterate; pilot	BSB with other expertise throughout the sector	4.7.4 9.3.2 9.3.3
Build the evidence base for effective social impact – draw from international experience	BSB, product designers, SFIs social impact networks (US, Europe and UK)	4.7.4

### 10.2.3 Fiscal assistance

Recommendation	Suggested possible contributors	Reference In report
Create fiscal incentives to invest in charities and social enterprises	H M Treasury assisted by BSB	4.7.4 7.2 8.6
Reduce restrictions on social enterprise sectors eligible for tax relief e.g. under Enterprise Investment Scheme and Venture Capital Trust to be able to include nursing and residential care homes and to cover personal lending and social housing under CITR; allow VCT investments in Community Interest Companies (CICs) regardless of the trading activity of the CIC	H M Treasury assisted by BSB and other social financial intermediaries	8.6 4.3.4 7.4
Send out clear message to retail banks that Enterprise Finance Guarantee Scheme (EFGS) is widened to cover all lending to CDFIs	H M Treasury ; BSB to champion case, Dept of Business, Innovation and Skills	8.6 4.3.4
Consider providing tax relief to individuals for investments lost to social enterprises; repeat the call for tax breaks to CICs	H M Treasury ; BSB lobbying assistance,	4.7.4
Build up greater knowledge amongst social enterprises of the tax relief that investors might be eligible to when investing into their organisation	SFIs, Business Link, BSB, support agencies, social enterprise agencies and advisory services, accountancy service providers	4.7.4

### 10.2.4 Building up economies of scale

Recommendations	Suggested possible contributors	Reference In report
Build up scale with combined back office functions on impact measurement, product design, database sharing, central point for investment information	SFIs to develop capacity; BSB oversight	4.5.4
Create pooled funds as suggested to generate scale and generate larger investment opportunities; leverage in institutional finance by liaising with champions on product design (e.g. for public sector spin-outs and for Charities looking for Mission Related Common Investment Fund)	Product innovators private financiers, with support from BSB Private wealth managers	4.2.3 4.4.4 4.7.2 7.4.2
Create a Special Purpose Vehicle staffed to provide due diligence and enterprise research to work closely with investment fund managers	SFIs	4.2.3 4.7.4

### 10.2.5 Government policy

Recommendations	Suggested possible contributors	Reference In report
Provide clarity on role for social enterprises and the recognition of impact creation in commissioning, contract and procurement processes ,	Dept. of Communities and Local Government, Office of Civil Society, local authorities, BSB support	4.6.4 8.6 9.3.7
Provide clarity on definitions of civil society organisations able to secure financial on-lending from BSB	Dept. of Communities and Local Government, BSB, Merlin Banks	8.1 8.6 9.2
Build up evidence of use of government investment funds into the sector to date: identify what works best	Social Investment Bank, BSB, Cabinet Office of Civil Society	8.4, 8.6
Provide guidance to local authorities and commissioners in identifying of potential savings as a basis for commissioning	Dept. of Communities and Local Government, Office of Civil Society, local authorities, BSB support, social financial intermediaries	4.6.4 8.6 9.3.7

Government to consult on proposals to establish bespoke community and social finance regulatory regime	Financial Services Regulator, H M Treasury, Social Financial Intermediaries and product creators, lawyers advising social and charitable sector	4.8.2
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### 10.2.6 Product development, considering mitigation of risk

Recommendation	Suggested contributors possible	Reference In report
Ensure product design and investable enterprises keep pace with each other; generate an efficient pipeline between capital raised and enterprises to invest in	UnLtd, other business support providers, Business Link, social sector consultancies	4.7.4
Design products which help to improve liquidity as an important risk mitigating strategy	BSB, product designers	4.2.3 4.4.4
Consider further innovative use of EU and other institutional funds to underwrite investment vehicles and support the sector more generally	European Commission, BSB, local authorities, Dept. of Communities and Local Government, Local Economic Partnerships	4.2.4 7.4
Identify where there will be a probable need for mitigation of risk in product design; allocate resources for underwriting investments to create market opportunity	BSB, foundations, local authorities, product designers	4.5.4 7.2 9.3.2
Know the target investor and create the product to appeal to that type of investor; many products required for many types of investors	product designers, social financiers, social financial intermediaries, NESTA	4.2.3 7.2 7.4 7.5
Seek out best practice on product designs globally; exchange ideas with mainstream investment products	Social financial intermediaries, product designers, social entrepreneurs, social investors	4.5.4 4.7.4 7.2.4
Determine likely and actual take up rate of different products; examine reasons for success and failure within the sector	BSB, SFIs, social investment business, Cabinet Office, NESTA	4.2.3 7.4
Establish which of the new products under development are most attractive to which investors; build on these further	NESTA, product developers, SFIs	4.7.4 7.4.7

### 10.2.7 Mentoring

Recommendation	Suggested contributors possible	Reference In report
Use the commercial investors' expertise to provide mentoring to enterprises who seek and secure finance	Commercial and social investors, social financial intermediaries, NESTA, mentoring institutions	4.3.4 4.6.4
Assess the strength of the previous Social Enterprise Access to Finance Initiative and consider a revised version to support new and developing social enterprises	NESTA, UnLtd, social financial intermediaries	4.7.4
Provide specific support for public sector spin-outs at early stages of spin-out; help with assessment of financial needs; build this support into investment pools	BSB team for public sector support, Social Financial Intermediaries, Social Investment Business, social business consultancies	7.4 8
Continue to assist businesses in understanding their financial needs at different stages in the business cycle; build up a bank of case studies to illustrate key points around balance of impact and scale	SFIs including UnLtd, Special Purpose Support unit within BSB, academics in the sector	4.7 9
Provide specific sector knowledge and resources to help open doors for contracts or markets; help social enterprises to work in collaboration with commercial organisations	UnLtd, SFIs, NESTA,	5 9
Build on expertise within institutions, foundations and intermediaries to provide further long term support to entrepreneurs in the sector	Charitable foundations, Social Financial Intermediaries, NESTA, BSB, UnLtd, pro-bono support from institutional investors	4.5.4

### 10.2.8 Infrastructure

Recommendation	Suggested possible contributors	Reference In report
Open up social investment opportunities to a wider range of investors; support creation of the platforms and vehicles	BSB, product and platform designers	7.4 7.4.8
Once platforms are in place, develop robust well-publicised routes to market to increase take – up of opportunities	BSB and platform providers, sector PR agencies	7.4 9.3.5
Build up the infrastructure in a co-ordinated manner, ensuring the development is not fragmented but seeks to include the mainstream investors and companies	Product designers, investors of platforms, BSB and social financial intermediaries	7.4.8
Use effective mechanisms to match types of finance required with types of finance offered	Platforms, Social Financial Intermediaries, Social Investment Business, NESTA	4.7.3 7.3

### 10.2.9 Develop sector data on financial performance

Recommendation	Suggested possible contributors	Reference In report
Analyse and publicise sector performance, produce data that reflects its strengths (e.g. alleged low default rate, improvements in financial returns on investment, low beta etc.).	BSB's research arm, other financial intermediaries, think tanks and consultancies to the sector, Cabinet Office	5.2 8.6 9.3.1
Examine stocks and flows of working capital and growth capital provided; establish whether supply of capital does trigger 'investable demand'	Social financiers, Social Investment Business, UnLtd, think tanks	9.3.1



### 10.2.10 Champion and PR for the sector

Recommendation	Suggested possible contributors	Reference In report
Represent the sector widely beyond the UK; engage with other networks of best practice in the sector	BSB, social sector generally	4.8.4 9.3.6
Champion the good news stories, develop honest and open discussion about its successes and failures; publish the track records as they build up, make these available to institutional investors and the commercial sector; build up concept of social enterprises as potential partners to commercial organisations	BSB, social enterprises, intermediaries, NESTA,	8.6 9.3.6
Develop efficient PR for the sector and its innovators	BSB, SFIs, product developers, sector ambassadors	9.3.6
Find the champions within organisations and work with them to overcome barriers to social investment	Product developers, Social financial intermediaries	4.3.4 4.4.4
Work with enthusiasts in public, commercial, financial sectors – find the champions	ALL within the sector	4, 7, 8, 9

## 11 Conclusion

This report provides a snapshot of institutional perspectives on social investment. As such, it offers a guide to how different investors may become engaged in financing the sector. We see that homogenous product design is not the answer – no one size or shape fits all. Social enterprise is working towards developing business models and products that approach the requirements of investors, but until the track record is established, there will be some need for underwriting of investments to secure the sector's long term growth.

The social sector is full of innovators, entrepreneurs and financiers with commitment to bring about a new way of doing business. And it contains unique selling features to offer the business and financial world. For example, social initiatives that fundamentally change a business proposition through the social impact generated are particularly interesting to investors. The City Car Club and Social Impact Bonds are examples of these 'progressive' initiatives and further innovations are on the way. Furthermore, ClearlySo sees the value that social enterprise offers in collaborating with its commercial counterparts, using its expertise in creating and measuring impact. Investors are also attracted to such propositions. The sector is ready to work with financiers, grant givers, entrepreneurs and government to help make this happen, in its ambition to create lasting social impact.

## 12 List of abbreviations

AIFA	Association of Independent Financial Advisors
BSB	Big Society Bank
CC	Charity Commission
CDFI	Community Development Finance Institutions
CIC	Community Interest Company
CITR	Community Interest Tax Relief
CLG	Company Limited by Guarantee
CLS	Company Limited by Shares
CRA	Community Reinvestment Act, US
CSR	Corporate Social Responsibility
EIRIS	Experts in Responsible Investment Solutions
EIS	Enterprise Investment Scheme
ESG	Environmental Social and Governance
HCT	Hackney Community Transport
HNWI(s)	High Net Worth Individual(s)
IFA	Independent Financial Advisor
IFS	Institute of Financial Consultants
ISA	Individual Savings Account
LEP	Local Economic Partnerships (replacing RDAs)
MCI	Mission Connected Investment (of charitable foundations)
NESTA	National Endowment for Science Technology and the Arts
OEIC	Open Ended Investment Company
PRI	Programme Related Investment (of charitable foundations)
RDA	Regional Development Agency
RDR	Retail Distribution Review
SEIF	Social Enterprise Investment Fund
SFI	Social Financial Intermediary
SIPP	Self Invested Personal Pension
SRI	Socially Responsible Investment
SVCT	Social Venture Capital Trust
UKSIF	United Kingdom Sustainable Investment Forum
UNPRI	United Nations Principles of Responsible Investing
VCT	Venture Capital Trust

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## 14 Members of the Advisory Panel

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## 15 Matrices of Social Investment Vehicles

The following tables are a selection of different social investment vehicles in existence or under development.

<b>BIG ISSUE INVEST 1</b> Listed Social Investment Fund to invest in UK exchange-listed equity and unlisted early stage social businesses Contact: Sarah Forster, sarah@bigissueinvest.com	Asset class / vehicle features
£35 – £50m fund	Size
Varied according to business performance	Expected financial return
Varied according to business sphere but all will meet a social impact benchmark test	Expected social return
Trust trades as a company with a daily price at a premium or loss against its Net Asset Value	Liquidity
Varied according to sector; fits in the micro cap / equities pot	Impact measure
Taxes operate at a company level, can offset gains against losses for tax purposes	Tax benefits
Broad ranging (e.g. healthcare, education, training, others)	Causes/ sector
Not high from share owners but from BII potentially high	Level of engagement
Open to any size- suitable for retail and eventually more for institutional investors	Individual investment size
Could be perceived as high risk until track record is established, could trade at a discount	Risk / return ratio
Charitable trusts and HWNIs, Private client stock brokers and fund managers could use their micro-cap allocation for this. Expect 70% foundation clients and 30% retail investors (could be via IFA); in further rounds could issue new shares.	Target investors



<b>BIG ISSUE INVEST 2</b> <b>Social Enterprise Investment Fund LP to invest in the scale-up of UK social enterprises</b> <b>Contact: Sarah Forster, sarah@bigissueinvest.com</b>		<b>Asset class / vehicle features</b>
Target size of £10 million; £7.5 million raised as of June 2011		<b>Size</b>
Target net IRR of 3-5%		<b>Expected financial return</b>
High social impact measured according to BII's Impact Index. Expected impact areas include poverty alleviation, job creation for disadvantaged groups, improved health outcomes		<b>Expected social return</b>
10 year close ended fund; Limited Partnership structure		<b>Liquidity</b>
Impact Index which looks at quantifiable and qualitative social performance metrics related to impact area and degree of business innovation.		<b>Impact measure</b>
No tax benefits for investors. Donations can be made through Charities Trust and attract gift aid.		<b>Tax benefits</b>
Five core investment themes: Jobs, Education & Training; Health and Social Care; Financial Inclusion: Environment w. community benefit; Asset-backed Community Development		<b>Causes/ sector</b>
Act as an engaged investor; non-exec Board seat plus help find business support, if required		<b>Level of engagement</b>
£200,000 - £500,000 w no more than 20% of Committed Capital in any one enterprise		<b>Individual investment size</b>
Could be perceived as high risk given no proven track record. Regarded as a demonstration fund to prove investing in social enterprise can deliver reasonable financial returns and high social impact.		<b>Risk / return ratio</b>
Foundations, financial institutions, family offices/trusts, individuals. Only open to qualified investors.		<b>Target investors</b>

<b>THE KEY FUND</b> <b>Lead-in funds (loan and grant), loans, equity</b> <b>Contact: Ann Oldroyd. ann.oldroyd@thekeyfund.co.uk</b>		<b>Asset class / vehicle features</b>
£12m capital and revenue grants and loans invested in sector £5m recycling Fund Currently £.5m bank facility, £100k trust facility		<b>Size</b>
Legacy from ERDF and other public funds granted for lending		<b>Expected financial return</b>
Increased jobs for BAME, Women, Disabled Increased jobs in communities Enabler		<b>Expected social return</b>
Potential access to £6m new capital and £3m bank facility: £3m over 2 years; £6m over 5 years with corresponding returns from 3-5 year loans. Target capital fund portfolio at year 8 of £10m less support grants for new businesses and investment readiness		<b>Liquidity</b>
Reduction in people on long term unemployed register. Increased disposable income in communities. Increased community owned assets. Support to local business		<b>Impact measure</b>
None apply as yet		<b>Tax benefits</b>
Civil Society – all sectors. Particular interest in renewables/recycling; CDT, community owner assets/enterprise. Comment on SROI. Loan return rate. Default rate and why		<b>Causes/ sector</b>
Mentoring Board membership		<b>Level of engagement</b>
N/A		<b>Individual investment size</b>
N/A		<b>Risk / return ratio</b>
Future: Regional Growth Fund Private Charitable Trusts High Net Worth Individuals		<b>Target investors</b>

<b>HEALTHCARE IMPACT FUND</b> <b>Finances time-limited projects dedicated to improving patient and economic outcomes</b> <b>Contact: Ratna Singh ratna.singh@ihpclinics.com</b>	Asset class / vehicle features
	Size
	Expected financial return
	Expected social return
	Liquidity
	Impact measure
	Tax benefits
	Causes/ sector
	Level of engagement
	Individual investment size
	Risk / return ratio
	Target investors

<b>SOCIAL IMPACT BONDS</b> (using the Peterborough Re-offending SIB as an example) Contact: <a href="http://www.socialfinance.org.uk">www.socialfinance.org.uk</a>		<b>Asset class / vehicle features</b>
£5 million raised; will be drawn evenly over 6 years. Future impact bonds likely to be larger		<b>Size</b>
If there is a drop in re-offending beyond 7.5%, investors will receive an increasing return capped at 13% p.a. over an 8-year period. A 10% reduction would result in a 7.5% p.a. return		<b>Expected financial return</b>
The support to prisoners provided by St. Giles Trust (one of the service delivery organizations) has been shown to reduce re-offending by as much as 40%.		<b>Expected social return</b>
£5 million will be drawn evenly over 6 years. Returns at the earliest in year 4 and are received evenly thereafter		<b>Liquidity</b>
Reduction in reconviction events relative to the experience with a control group of short-sentence prisoners in the UK		<b>Impact measure</b>
None apply as yet		<b>Tax benefits</b>
Recidivism; potential future areas of application include looked after children, drug treatment and health care		<b>Causes/ sector</b>
Investors represented on Social Impact Partnership board and sub-monitoring groups		<b>Level of engagement</b>
Not specified		<b>Individual investment size</b>
High risk levels – capital not protected; annualised return capped at 13%		<b>Risk / return ratio</b>
Charitable Trusts / HNWI's. Socially motivate the private investors		<b>Target investors</b>

<b>RESONANCE COMMUNITY SHARE UNDERWRITING FUND</b> (for social enterprises to purchase asset whilst marketing community share offer) Contact: Daniel Brewer info@resonance.ltd.uk		Asset class / vehicle features
£2m target fund size		Size
c.6%		Expected financial return
Community shares would allow for housing for disabled adults, workspace for community groups, community woodland purchase		Expected social return
Bridging loans for up to 50% of equity sought repayable in up to 5 years through further share issues.		Liquidity
Number of vulnerable adults housed, number of businesses provided with workspace, hectares purchased, grant free affordable homes provided through underwriting of shares		Impact measure
Could be eligible for CITR		Tax benefits
Housing for disabled, community businesses, farm forestry and renewables		Causes/ sector
High engagement levels		Level of engagement
£25,000-£500,000 Average size expected to be £300,000		Individual investment size
Risks limited by only financing projects with track record and with asset backing; project failure risk		Risk / return ratio
Charitable Trusts CDFIs Professional investors		Target investors

<b>FINANCE SOUTH EAST AND RESONANCE SOCIAL IMPACT CO-INVESTMENT FUND.</b> <b>Contact: Sally Godsell, sally.godsell@financesoutheast.com</b>		Asset class / vehicle features
Target £2.5m		Size
5%		Expected financial return
Leverage of angel investment and support into high impact UK social enterprises		Expected social return
Loans are offered for up to 5 years		Liquidity
Growth of social enterprises using transformational index		Impact measure
None – possibly eligible for CITR		Tax benefits
All		Causes/ sector
Low involvement from the fund, but expected high engagement from angel		Level of engagement
50k		Individual investment size
Risks reduced through involvement of angel		Risk / return ratio
Charitable foundations		Target investors

<b>RESONANCE SOCIAL CARE PROPERTY FUND</b> <b>Contact: Daniel Brewer, info@resonance.co.uk</b>		Asset class / vehicle features
Target £20m		Size
10%		Expected financial return
Allows social enterprises to provide further services in homelessness, education and community development		Expected social return
7 year term plus up to 2 one year extensions		Liquidity
Further development of charitable cause through release of cash for social enterprises owning assets		Impact measure
None		Tax benefits
Social Care		Causes/ sector
High level of engagement with tenants		Level of engagement
£100,000+		Individual investment size
Risks reduced - asset backed investment; potentially suited to charities with public sector contracts, now possibly threatened		Risk / return ratio
Pension Companies, charitable foundations, HNWLs		Target investors

<b>SOCIAL STOCK EXCHANGE LTD.</b> <b>An FSA regulated platform to enable trading of securities of social businesses</b> <b>Contact: Pradeep Jehti, pjethi@gmail.com</b>		Asset class / vehicle features
£2m development fund		Size
C 13% IRR, but expect 6years before profitability as number of companies listed increases		Expected financial return
Increased investment through easy engagement, allowing extra capital raised for social businesses		Expected social return
SSE Ltd will trade but may be until profitability established, will be fairly illiquid		Liquidity
Companies listed will be over £10m market cap and will have already delivered and measured their social impact against a range of sector relevant metrics to achieve listing		Impact measure
Target figure of £2m sought before closure of investment opportunity		Tax benefits
None		Causes/ sector
Wide range of health. Social education, environment, clean tech, forestry organic etc.		Level of engagement
Not high in principle for end investor, development investor may be able to engage more fully in SSE creation Board seat available to equity investor in SSE		Individual investment size
£250K +		Risk / return ratio
13% IRR no capital returned; high risk venture; small balance sheet low fixed assets		Target investors
Foundations, HNWLs; US institutional investors		Social Investors

<b>FRANCHISINGWORKS</b> <b>Loan. Self-employment investment fund.</b> <b>Contact: Simon McNeill-Ritchie, Programme Director,</b> <b><a href="http://www.franchisingworks.org">www.franchisingworks.org</a></b>	<b>Asset class / vehicle features</b>
£6 million facility, to be drawn evenly over 3 years.	<b>Size</b>
12%	<b>Expected financial return</b>
500 unemployed moved off benefits into sustainable self-employment. A further 1500 jobs created directly within 5 years. Approximately 2,000 jobs created or secured indirectly Creation of 500 new, sustainable businesses in deprived areas.	<b>Expected social return</b>
£6 million will be drawn evenly over 3 years.	<b>Liquidity</b>
No. of business start-ups, growth and jobs created	<b>Impact measure</b>
None apply as yet. Possible EIS qualification for private investors.	<b>Tax benefits</b>
Unemployment. Future areas of application include youth unemployment, ex-armed forces and ex-offenders.	<b>Causes/ sector</b>
Investors represented on investment board.	<b>Level of engagement</b>
Not specified	<b>Individual investment size</b>
Medium risk levels – capital not protected, but securitised against business assets (licences). Diversified business sectors	<b>Risk / return ratio</b>
Social Investment Institutions, banks, socially-motivated HNWLs and private investors.	<b>Target investors</b>



<b>CHARITY BANK</b> <b>Medium Term Note Programme allowing a generic bond platform for charities to raise capital</b> <b>Contact: Geoff Burnand, gburnand@charitybank.org</b>	Asset class / vehicle features
£1m min each	Size
Margin over UK government gilts	Expected financial return
Varied according to issuing charity trade-ability	Expected social return
Listed, so gives pricing and therefore	Liquidity
Varied according to issuing charity, but social impact reporting will be critical to the issuance of the bond	Impact measure
none	Tax benefits
Household named charities – health, elderly, social care etc.	Causes/ sector
Not specified but could be high	Level of engagement
£10,000 or multiples of this	Individual investment size
Varying according to issuing charity, but bond structure is well understood and adds to financial options	Risk / return ratio
SRI funds, wealth managers and their clients; public and private foundations under MCI strategies	Target investors
Charitable trusts, HNWIs, Private bank clients, Move towards SRI investments	Social Investors

<b>BRIDGES SOCIAL ENTREPRENEURS FUND</b> Contact Bridges Ventures: <a href="http://www.bridgesventures.com">www.bridgesventures.com</a>	<b>Asset class / vehicle features</b>
£11.75m for investment in scalable social enterprise delivering high social impacts and operating sustainable business models. Note that this fund is now closed for new investment.	<b>Size</b>
Net return of c. 3-5%	<b>Expected financial return</b>
At the time of investment, we agree specific social impact metrics and targets with the entrepreneurs we back	<b>Expected social return</b>
10 year fund (closed in Aug 2009)	<b>Liquidity</b>
See "expected social return"	<b>Impact measure</b>
None apply	<b>Tax benefits</b>
The fund is not restricted to any sector and invests across the range of social enterprise models	<b>Causes/ sector</b>
Hands-on support provided to help social entrepreneurs realise their ambitions and maximise their social impact; usually engage post-investment through Board representation	<b>Level of engagement</b>
Up to £1.5m in each social enterprise	<b>Individual investment size</b>
The fund invests across a range of risk / return profiles	<b>Risk / return ratio</b>
Investors /donors include foundations, individual donors, government, NESTA and the Bridges Ventures team have allocated funds from their profit share	<b>Target investors</b>

<b>ALLIA (PREVIOUSLY CITYLIFE)</b> <b>Bonds tiered financing product comprising a gift and loan in one bond</b> <b>Contact: Phil Caroe. phil.caroe@allia.org.uk</b>		<b>Asset class / vehicle features</b>
	£16m to date raised; currently offering up to £10m of bonds	<b>Size</b>
	100% of capital plus flexible interest rate up to 10% on maturity (allowing investors to choose proportion of yield donated up front); bespoke provision available for major corporate investments	<b>Expected financial return</b>
	Gift element of the bond donated up front to charity of choice from selected list of beneficiary organizations; charities may also be proposed by investors	<b>Expected social return</b>
	5 years; bonds are transferable, thus adding to the liquidity; early redemption possible at Allia's discretion	<b>Liquidity</b>
	Benefiting charity's results; reported by the charity and can be measured by Allia's own company, Future business, whose staff are accredited in the SROI methodology	<b>Impact measure</b>
	Allia is an exempt organization that receives, and pays, investment interest gross	<b>Tax benefits</b>
	Allia supports charitable causes in any sector that are delivering social outcomes	<b>Causes/ sector</b>
	None from holding the bond directly	<b>Level of engagement</b>
	Minimum £100, maximum currently £10m but negotiable	<b>Individual investment size</b>
	Risk and returns are low; strong track record, based on investment in AA rated social housing provider in returning capital plus interest, funds held fully under independent trust; careful selection of charities to receive donations	<b>Risk / return ratio</b>
	Socially minded individual investors, possibly Charitable Trusts; Corporations looking to invest surpluses and donate (possibly as part of their CSR strategy)	<b>Target investors</b>

<b>BONDS HELD IN DIFFERENT COMPANIES, OR COLLECTION OF COMPANIES</b>	<b>Asset class / vehicle features</b>
Varied	<b>Size</b>
Average 4%+	<b>Expected financial return</b>
Social loans define the social targets sought from the capital raised	<b>Expected social return</b>
Could be sold on if bond is listed; unlisted bonds harder to generate liquidity	<b>Liquidity</b>
Tied to loan. Methodology differs. Social Impacts recorded	<b>Impact measure</b>
Limited maybe CITR eligible (depends on area of investment)	<b>Tax benefits</b>
Varied, all range of social enterprises could issue bonds	<b>Causes/ sector</b>
Not usually given seat on Board with bond holding	<b>Level of engagement</b>
Varied according to company's requirements	<b>Individual investment size</b>
Medium risk; as sector is still fragile;	<b>Risk / return ratio</b>
Social Venture financiers e.g. Charitable foundations, social venture funds with strong reputations	<b>Target investors</b>

<b>QUASI EQUITY</b> (usually based on a revenue participation scheme where equity cannot be issued, e.g. in Charities)		<b>Asset class / vehicle features</b>
Varied; maybe part of a larger financing package		<b>Size</b>
% of revenue increase above agreed benchmark		<b>Expected financial return</b>
Agreed target levels of social impact defined with investors		<b>Expected social return</b>
Illiquid usually, tied in to loan period (c 3-5 years typically)		<b>Liquidity</b>
Depends on issuing company; financiers and bond issuers to agree acceptable method of measurement and reporting of social impact		<b>Impact measure</b>
CITR could apply depending on sector and locality		<b>Tax benefits</b>
Varied : example in community and public transport		<b>Causes/ sector</b>
Considered like equity so usually seat on Board or on other executive committees		<b>Level of engagement</b>
Varied according to company's requirements		<b>Individual investment size</b>
Higher risk and potentially higher returns than conventional loan; return usually tied to revenue not profit; depends on track record and sector of company in the social enterprise sector.		<b>Risk / return ratio</b>
Social investors, and potentially mainstream investment fund managers (varies on a case by case basis)		<b>Target investors</b>

<b>SCOPE TIERED FINANCE</b> <b>Grangewood Venture Philanthropy Project, combines gift and loan finance to secure a commercial loan on property.</b> <b>Contact: Tom Hall, tom.hall@scope.org.uk</b>	Asset class / vehicle features
	Size
	Expected financial return
	Expected social return
	Liquidity
	Impact measure
	Tax benefits
	Causes/ sector
	Level of engagement
	Individual investment size
	Risk / return ratio
	Target investors
Gift plus loan at a minimum 1:4 ratio. This capital allows for a long term loan from social banks	
100% of loan repaid – no interest to individual; commercial loan on property paid at 3 -6 % AER from social lender	
Package sought for disabled accommodation; number of people provided with accommodation	
3 year tie-up; commercial loan on new build secured for 10 – 15 year for bank loan backed against new buildings	
Number of disabled people now in suitable housing	
Gift Aid & tax relief on donation	
Disabled accommodation	
Not specified	
Package of £1750 donation (£2,800 gross less £1050 tax relief) and £7000 loan	
Low risk low asset backed return from sale of land; high social impact	
Target investors: HNWI's, socially minded investors; private wealth advisors might direct clients to this	

<b>CAF VENTURESOME</b> <b>Loans, equity, quasi-equity, standby facilities</b> <b>Contact: cafonline.org</b>		<b>Asset class / vehicle features</b>
£10 million, plus currently fundraising for the CAF Social Impact Fund		<b>Size</b>
Investments are made either as a gift; or patient capital; or at a rate of 0% (i.e. return of capital)		<b>Expected financial return</b>
Cash flow and capital support that enables charities and social enterprises in various areas of impact to deliver on their mission		<b>Expected social return</b>
Management of the underlying investments to match investor repayment profiles.		<b>Liquidity</b>
Set targets for each investment on a case by case basis. For growth capital investments we set social impact indicators and milestones from the outset.		<b>Impact measure</b>
None		<b>Tax benefits</b>
Cause agnostic, broad range of areas of impact.		<b>Causes/ sector</b>
Investors receive reports every 6 months, including updates on financial and social metrics for individual investments		<b>Level of engagement</b>
£10,000+		<b>Individual investment size</b>
Varies by Fund; the Development Fund is higher risk with potentially higher attributable social impact; the CAF Social Investment Fund is low risk so expect full return of capital.		<b>Risk / return ratio</b>
Charitable Trusts; HNWLs; CAF Trust clients; corporate foundations		<b>Target investors</b>

<b>ETHEX</b> <b>A non-profit club designed to stimulate small investment into social businesses by the informed public</b> <b>Contact: Jamie Hartzell, Jamie@ethex.org.uk</b>		<b>Asset class / vehicle features</b>
£250,000 participatory loan		<b>Size</b>
6%		<b>Expected financial return</b>
Increased investment in social business plus broadened participation by investors in society		<b>Expected social return</b>
Loan repaid over 10 years		<b>Liquidity</b>
Amount invested in social business, number of businesses able to offer a suitable investment product		<b>Impact measure</b>
None		<b>Tax benefits</b>
Wide range of fairtrade, community finance, health, social education, environment, clean tech, forestry organic etc.		<b>Causes/ sector</b>
Board seat available if required		<b>Level of engagement</b>
£100K +		<b>Individual investment size</b>
Return dependent on performance.		<b>Risk / return ratio</b>
Foundations and HNWLs;		<b>Target investors</b>



<b>TRUESTONE GLOBAL IMPACT FUND</b> <b>Run by Truestone Asset Management</b> <b>Contact: Ben Stevens ben.stevens@truestone.co.uk</b>		<b>Asset class / vehicle features</b>
£10m currently		<b>Size</b>
C8% net back to the investor		<b>Expected financial return</b>
Varied ranging over sectors and geography		<b>Expected social return</b>
Fund is structured as an OEIC. It should be considered as a long-term investment and part of a well-structured balanced overall portfolio. 50% of investments will be held in private equity and 50% in open liquid structure. Monthly pricing.		<b>Liquidity</b>
DeLoitte's auditing statements on the social returns of the fund as measured through collation of numerous Key Performance Indicators from the fund's portfolio. Truestone own monitoring processes through regular monthly and quarterly reporting from investments		<b>Impact measure</b>
None to date		<b>Tax benefits</b>
Various sectors in UK and globally; social and environmental		<b>Causes/ sector</b>
Actively encourages engagement from clients and employees; engaged with investee companies		<b>Level of engagement</b>
£25,000 minimum, no maximum		<b>Individual investment size</b>
Higher risk in frontier areas but managed with monitoring and extensive due diligence. Fund aims to deliver market rate returns in combination with risk reduction strategies		<b>Risk / return ratio</b>
Socially motivated individual investors, institutional investors		<b>Target investors</b>

SOCIAL ENTERPRISE PUBLIC EQUITY OFFERINGS (Adapted from Hartzell, 2007 in Nicholls, 2008)				
Company	Date	Legal form	Type of investment PLC	Amount raised (£m)
Traidcraft	1984	PLC	Share	n/a
Mercury Provident	1985	PLC	Share	0.3
Traidcraft	1986	PLC	Share	0.5
Paperback	1987	IPS	Loan stock	1
ICO Fund	1987	IPS	Loan stock	0.05
Centre for Alternative Technology	1990	PLC	Share	0.5
Mercury Provident	1991	PLC	Share	1
Traidcraft	1991	PLC	Share	0.4
Ecological Trading Company	1993	PLC	Share	0.4
ICOF Community Capital	1994	IPS	Accessible share capital	0.2
Paperback	1994	IPS	Loan stock	0.45
Out of This World	1995	IPS	Loan stock	0.07
Shared Interest	1995	IPS	5-year loan stock	1
Wind Fund PLC	1995	PLC	Share	0.65
Bay Wind	1996	IPS	Accessible share capital	1
Out of This World	1996	IPS	Loan stock	1.2
Shared Interest	1996	IPS	5-year loan stock	0.2
Aston Reinvestment Trust	1997	IPS	Accessible share capital	0.85
Out of This World	1997	IPS	Loan stock	0.41
Shared Interest	1997	IPS	5-year loan stock	0.2
ICO Fund	1997	IPS	10-year loan stock	1.2
Shared Interest	1999	IPS	5-year loan stock	1.32
Citylife (Sheffield)	1999	IPS	5-year bond	1
Monkton Group (Good Energy)	2001	PLC	Share	0.8
Shared Interest	2001	IPS	5-year loan stock	0.66
Citylife (Newcastle)	2001	IPS	5-year bond	1
Traidcraft	2002	PLC	Share	2
Ethical Property Company	2002	PLC	Share	3.25

SOCIAL ENTERPRISE PUBLIC EQUITY OFFERINGS (Adapted from Hartzell, 2007 in Nicholls, 2008)				
Company	Date	Legal form	Type of investment PLC	Amount raised (£m)
Shared Interest	2002	IPS	5-year loan stock	4.2
London Rebuilding Society	2002	IPS	Accessible share capital	1
Citylife (East London)	2002	IPS	5-year bond	0.06
Unicorn Wholefoods	2003	IPS	Loan stock	1.9
Shared Interest	2003	IPS	5-year loan stock	0.3
Golden Lane Housing	2003	Charity	10-year bond	1
Cafédirect	2004	PLC	Share	1.5
Monkton Group (Good Energy)	2004	PLC		5
Shared Interest	2005	IPS		0.66
Triodos Renewable Energy Fund (formerly Wind Fund PLC)	2005	PLC	Share	1
				4.75
Westmill Wind Farm	2005	IPS	Share	3.75
Ethical Property Company	1999	PLC	Share	0.67
Total				50.1
Source: Hartzell, 2007 in Nicholls, A., 2008. <i>The Landscape of Social Investment: A holistic topology of opportunities and challenges</i> . Oxford Said Business School.				

APPROACHES TO PERFORMANCE MEASUREMENT USED FOR SOCIAL ENTERPRISE	
DESCRIPTION	PERFORMANCE MEASUREMENT
This model requires an organisation's accounting system to incorporate not only the traditional measures of financial performance, but also social and environmental outcomes.	Triple Bottom Line
This model is built around three sets of linked metrics: impact measures, activity measures and capacity measures.	Family of Measures
Blended value represents the conceptualisation of organisational output as a single metric factoring in all economic, social and environmental value. This develops the Triple Bottom Line approach.	Blended Value
Social audits or accounts capture subjective user and other stakeholder experience along with any quantitative measures.	Social Auditing
The <i>balanced scorecard</i> approach rates organisational performance against a broad basket of financial and social indicators, including staff policies.	Balanced Scorecard
SROI aims to monetise all social and environmental outcomes and combine them with economic outputs to provide a single financial output figure. This is then with (similarly discounted) input costs to produce a social ROI. discounted by time and risk and compared	Social Return on Investment
Building a strong ethical or environmental brand can add value to a social enterprise and act as an intangible asset for borrowing or equity price setting.	Branding Valuation

Source: Nicholls, A., 2008. *The Landscape of Social Investment: A holistic topology of opportunities and challenges*. Oxford Said Business School.

## List of Participating Organisations

Again, our grateful thanks go to all those organisations listed below and to others who chose not to be named, for the time they spent on behalf of their organisations to take part in our research.

Allia	Jacana
AVIVA	Lankelly Chase
Barclays	Lloyds Development Capital
Bates Wells Braithwaite	Local Partnerships
Big Issue Invest	Mercers
Bridges Ventures	Monitor
Cabinet Office for Civil Society	NESTA
CAN/Permira	New Philanthropy Capital
Cass Business School	Octopus Investments
Cazenove	Panahpur Trust
CCLA	Portland Capital
CDFI	Price Waterhouse Coopers
Charity Bank	Rathbone Greenbank
City Bridge Trust	RCapital
City of London Corporation pension fund	Royal Bank of Scotland
Co-operative Bank	Sainsbury Family Charitable Trusts
Coutts Bank	Schroders Private Bank
Dan Gregory, Independent Advisor	Scope
Deutsche Bank	Seedrs
EIRIS	Social Finance Ltd
Equity Plus / Resonance	Social Stock Exchange
Esmée Fairbairn	The Key Fund
Ethical Investors	Triodos Bank
Ethical Property Company	Truestone Asset Management
Fair Finance	UBS
Fair Pensions	UKSIF
Friends Provident Foundation	Universities Superannuation Scheme
GAEIA Partnership	UnLtd Ventures
Helen Heap, Independent Advisor	Venturesome
Henderson Investors	West Midlands Pension Fund
Holden Advisors	Young Foundation
Impetus Trust	
Independent Health Partnership (IHP)	
Intergrated Health Partners	

## Raw Data

### SECTION 2: DRIVERS FOR SOCIAL IMPACT INVESTING

Which of these drivers influence your decision to impact invest?	Client or internal demand for impact investing	Adherence to international investment codes e.g. UNPRI	Market positioning/ competitive advantage	Revenue potential from impact investing	Post-credit crunch revision of investment strategy	No driver to invest in social enterprises	Member / trustee education	Improvement of mission	Total
Total	104	22	57	64	21	19	5	29	321
Percentage	32%	7%	18%	20%	7%	6%	2%	9%	
How will updates to CC14 affect your or clients' investment decision?	Potentially > 15% increase to MCI or PRI	Up to 15% increase to social investing	Small increase	No likely increase	Not sure	Don't know about these changes	Total		
Total	4	7	3	4	10	7	35		
Percentage	11%	20%	9%	11%	29%	20%			
Might you have unidentified demand for SI amongst your clients?	Highly likely	Possibly	Not sure	Unlikely	definitely not	Total			
Total	5	14	2	6	1	28			
Percentage	18%	50%	7%	21%	4%				
If yes, would you consider engaging in social investment to meet this demand?	Yes, actively seek to do so	Possibly	not sure	unlikely	definitely not	Total			
Total	17	10	3	0	0	30			
Percentage	57%	33%	10%	0%	0%				
If you engaged, would you seek financial returns from social impact investing?	Yes, comparable to traditional /market investment	Yes, but at reduced levels to traditional investment	Expect principal, at least, to be returned	No, prepared not to receive any financial returns	Don't know	Total			
Total	19	10	5	1	2	37			
Percentage	51%	27%	14%	3%	5%				

### SECTION 3: IMPACT INVESTING AS AN ASSET CLASS

Do you see SI as a potential alternative asset class, given your responses above?	Yes, already	Yes, emerging	Not yet / not sure	Unlikely	no never	not relevant	<b>Total</b>	
<b>Total</b>	2	10	13	1	0	4	<b>30</b>	
<b>Percentage</b>	7%	33%	43%	3%	0%	13%		
If so, do you think this would be important in influencing the supply of social investment capital available?	Yes, through increased credibility, awareness	Possibly attract greater interest	Not sure	Unlikely to have much impact	No impact on capital into this sector	Other	<b>Total</b>	
<b>Total</b>	9	8	5	6	1	4	<b>33</b>	
<b>Percentage</b>	27%	24%	15%	18%	3%	12%		
What key developments need to happen to reach this position? (rank in order of importance 1= High, 5= Low)	Track record of financial return	Track record of social return	Standardised measurement methodology of key variables	Accessibility of investment products through market structures	Congruous grouping of social investment products	Trade-ability of investment products	Other	<b>Total</b>
<b>Total scores</b>	108	80	62	61	19	27	0	<b>357</b>
<b>Percentage</b>	30%	22%	17%	17%	5%	8%	0%	

**SECTION 3: HOW ENGAGED IN SOCIAL INVESTMENT ARE THOSE SURVEYED?**

Has your organisation already made a social impact investment?	No, not at all	Tried, but failed	Not yet, but interested	Yes, one or more	<b>Total</b>					
<b>Total</b>	9	0	3	21	<b>33</b>					
<b>Percentage</b>	27%	0%	9%	64%						
In which sectors did you invest (please ring all relevant sectors)	Health	Social care	Education	<b>Total</b>						
<b>Total</b>	7	7	8	<b>22</b>						
<b>Percentage</b>	32%	32%	36%							
Is the investee's legal structure important?	Yes, vital	Relevant, not critical	Not important	Not sure	<b>Total</b>					
<b>Total</b>	5	8	12	1	<b>26</b>					
<b>Percentage</b>	19%	31%	46%	4%						
If yes, were investments made into asset locked enterprises? (e.g. charities, CICs, IPS etc)	Yes, all	No, none	Some	<b>Total</b>						
<b>Total</b>	2	5	13	<b>20</b>						
<b>Percentage</b>	10%	25%	65%							
Were social investment decisions primarily based on 'finance first' or 'impact first' considerations?	All impact first	All finance first	A mixture	Distinction is not determinant	<b>Total</b>					
<b>Total</b>	2	7	12	0	<b>21</b>					
<b>Percentage</b>	10%	33%	57%	0%						
Did the investment decision meet your expectations?	Yes, closely	Yes, in part	Neutral	Not sure yet	No, failed expectations	<b>Total</b>				
<b>Total</b>	7	4	1	9	1	<b>22</b>				
<b>Percentage</b>	32%	18%	5%	41%	5%					
Would you invest directly in an enterprise or via an intermediary social investment fund?	Only invest directly	Only invest via a fund	A mixture	Don't know	Using advice of a financial advisor	<b>Total</b>				
<b>Total</b>	7	3	11	1	1	<b>23</b>				
<b>Percentage</b>	30%	13%	48%	4%	4%					
What do you see as the key barriers to increased take-up of social investment generally? (rank 1 = high importance, 5= low)	Liquidity weakness	fiduciary duties	trading difficulties	Compromised financial returns	Social impact not easily quantified	Weak investment propositions	Investment size (in relation to DD)	Absence of other Investor Interest	<b>Total</b>	
<b>Total</b>	69	3	35	90	61	80	18	16	<b>372</b>	
<b>Percentage</b>	19%	1%	9%	24%	16%	22%	5%	4%		



#### SECTION 4: SOCIAL IMPACT MEASUREMENT

How important is it for you as an investor that social impact measurement is reliable?	Highly important	Fairly important	Neutral	Not very important	Not at all important	Don't know	Total	
Total	18	12	1	0	0	2	33	
Percentage	55%	36%	3%	0%	0%	6%		
How reliable do you consider existing social impact assessments to be?	Highly reliable	fairly reliable	Neutral	Not very reliable	Not at all reliable	Don't know	Trust them to be so	Total
Total	0	11	5	8	0	7	0	31
Percentage	0%	35%	16%	26%	0%	23%	0%	
How do you consider social impact is reliably best reported?	Prospectus/ brochure	Annual report	Social impact report internally created	External Assessment eg social audit	Investment manager's own assessment	Total		
Total	0	5	12	12	7	36		
Percentage	0%	14%	33%	33%	19%			
What would you expect a social enterprise to have in place to ensure it delivers its social impact	Defined mission and goal	Evaluation of achievement towards goals	System of measurement	Mission protection in MoU other structure	Others:	Total		
Total	158	90	118	32	0	398		
Percentage	40%	23%	30%	8%	0%			
How important are social impact comparisons for your investment decisions?	Essential	Preferable	Neutral	Irrelevant	Total			
Total	6	14	8	3	31			
Percentage	19%	45%	26%	10%				
If important, are you able to make such comparisons	Yes	In Part	No	Not relevant as yet/ don't know	Total			
Total	1	5	5	6	17			
Percentage	6%	29%	29%	35%				

**SECTION 5: SOCIAL INVESTMENT VEHICLES: WHICH FEATURES ARE MOST ATTRACTIVE TO INVESTORS?**

<b>Rating: 1 = high, 5 = low</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>Total</b>
<b>Expected financial rate of return (a % p.a.)</b>						
Total	19	9	2	2	0	<b>32</b>
Percentage	59%	28%	6%	6%	0%	
<b>Perception of risk:</b>						
Total	18	10	3	1	0	<b>32</b>
Percentage	56%	31%	9%	3%	0%	
<b>Investment range (minimum amount, maximum amount e.g. £25K&lt;X&lt; £5m)</b>						
Total	2	10	10	4	0	<b>26</b>
Percentage	8%	38%	38%	15%	0%	
<b>Liquidity of the vehicle</b>						
Total	3	8	10	5	0	<b>26</b>
Percentage	12%	31%	38%	19%	0%	
<b>Social impact methodology</b>						
Total	3	10	8	1	1	<b>23</b>
Percentage	13%	43%	35%	4%	4%	
<b>Structure of the fund/investment vehicle</b>						
Total	3	15	7	0	0	<b>25</b>
Percentage	12%	60%	28%	0%	0%	
<b>Level of engagement with investee</b>						
Total	3	7	4	3	3	<b>20</b>
Percentage	15%	35%	20%	15%	15%	
<b>Social mission of the investment</b>						
Total	8	6	6	2	1	<b>23</b>
Percentage	35%	26%	26%	9%	4%	
<b>Type of investment offered</b>						
Total	3	8	7	4	1	<b>23</b>
Percentage	13%	35%	30%	17%	4%	
<b>Availability of advice</b>						
Total	2	3	10	3	1	<b>19</b>
Percentage	11%	16%	53%	16%	5%	
<b>Access to products</b>						
Total	3	12	5	0	0	<b>20</b>
Percentage	15%	60%	25%	0%	0%	
<b>Reputation of product originator</b>						
Total	8	6	2	1	0	<b>17</b>
Percentage	47%	35%	12%	6%	0%	
<b>Tax incentives attracted by investment (e.g. EIS, CIFR, VCT....)</b>						
Total	1	5	4	0	7	<b>17</b>
Percentage	6%	29%	24%	0%	41%	

# SECTION 6: HOW FAR DO EXISTING SOCIAL INVESTMENT VEHICLES APPEAL TO INVESTORS?

Which of the social vehicles and product vehicles listed on the matrix did you already know about?	All	Some	One	None	Total	
Total	3	17	2	2	24	
Percentage	13%	71%	8%	8%		
Which, if any, of these might be of interest to your clients/investors?	All	Some	One	None	not sure	Total
Total	0	12	0	4	7	23
Percentage	0%	52%	0%	17%	30%	
Which of these would you or your clients consider investing in?	All	Some	One	None	not sure	Total
Total	0	4	2	2	15	23
Percentage	0%	17%	9%	9%	65%	
Would your organisation be interested in helping the sector to design new products that meet investors' requirements?	Yes	No	Maybe	Total		
Total	7	5	7	19		
Percentage	37%	26%	37%			













